Wicked Loans and Bad Banks*

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The crisis created by non-performing assets (NPAs) on the balance sheets of commercial banks, especially public sector (PSBs), does not go away. It only intensifies. An environment that triggered large inflows of foreign capital and a surge in credit after 2003 encouraged banks to explore new areas and terms of lending, which are responsible for the large exposures that are now turning bad. Having encouraged that environment with its policies, the government had been pretending that the problem is not serious enough to warrant emergency action. The reason was that it wanted to do the impossible: resolve a big problem with little money. But now time seems to be running out.

Data for all banks (public and private) relating to December 2016, compiled by Care Ratings (and reported in The Indian Express, 20 February, 2017) point to a 59.3 per cent increase over the previous 12 months to touch Rs. 6,97,409 crore. That amounts to 9.3 per cent of their advances, compared with an NPA to advances ratio of 3.5 per cent at the end of 2012. The annual increment in the NPA ratio, which stood at around one-half of a percentage point in the years ending December 2013 and December 2014, has risen rather sharply to 1.6 percentage points and 3.3 percentage points respectively in the years ending December 2015 and December 2016.

One reason for the acceleration in NPA growth is the more stringent conditions regarding recognition of assets as nonperforming imposed in 2015. Realizing that postponing bad debt recognition could result in the accumulation of stressed assets in bank balance sheets sufficient to create a systemic problem, the Reserve Bank in 2015 instituted an asset quality review to reclassify assets and reverse the practice of treating all restructured assets as standard assets. Once stressed assets are formally recognized as non-performing, the requisite provisions are set aside at the expense of short term profitability, and the banks are recapitalized, credit growth will see a revival, it was argued. The problem is that this is not happening because a large number of projects to which money had been lent during the boom period that preceded 2011-12, when investment rates rose sharply, were not ones to which the banking system should have been exposed. As these projects are all entering into the period when they find themselves unable to service their debt, loans are turning non-performing in quick succession. This trail of defaults is ensuring that the NPA ratio is not stabilising, once assets misclassified as restructured and standard are recognised as non-performing, as the RBI expected it would. More assets are turning bad.

As the Economic Survey 2016-17 recognised, under normal circumstances this would have threatened the banks concerned with insolvency, perhaps triggered a bank run, forced bank closure and even precipitated a systemic crisis. India is fortunate that a large part of its banking system is owned by the government. According to the Care Ratings figures referred to earlier, 24 public sector banks (PSBs) accounted for 88.2 per cent of the total NPAs with the public and private banks. Their NPA ratio stood at 11 per cent at the end of 2016, indicating that they have a disproportionate share of bad loans in total advances. According to the Survey, since there is belief that these banks have the backing of the government, which will keep them afloat, the bad loan problem has not, as yet, become a systemic crisis.

Unfortunately, matters are not all that simple. First, the situation in some of the public sector banks is much worse than the average NPA figure suggests. Five of them record NPA ratios that are above 15 per cent. Second, constrained by its ideological adherence to "fiscal prudence" and stringent deficit targets, the government's appetite to recapitalise these banks is waning. Spending on projects or welfare schemes appeals to voters. Funnelling money into banks does not, especially when they seem not to have exercised due diligence. This leaves the option of getting the banks to make do with whatever money the government gives them, and supplementing them with recovery of some part of the loans that are non-performing.

Recovery is a possibility because the bad assets accumulated in the course of the lending boom after 2003 were concentrated in large loans to the corporate sector. As of March 2016, large borrowers (with liabilities of Rs. 5 crore and above) accounted for 58 per cent of scheduled commercial bank advances and 86.4 per cent of gross NPAs. The top 100 borrowers accounted 16 per cent of total advances and 22.3 per cent of gross NPAs. Indeed, the gross NPA ratio of the top 100 borrowers rose from just 3.4 per cent in September 2015 to 22.3 per cent in March 2016, with the reclassification of restructured assets.

Unfortunately, the focus of the government and the RBI, is on finding ways in which the banks can help large business groups revive, rather than how banks can recover their dues and beef up their balance sheets. According to RBI data, the rate of recovery of NPAs of scheduled commercial banks through various channels (Lok Adalats, Debt Recovery Tribunals and the SARFAESI Act) has fallen from 22 per cent of amounts involved in cases referred to these channels and being considered by them at the March 2013 to 10.3 per cent by end-March 2016. The referred cases themselves exhaust only a small proportion of aggregate NPAs in the system. In fact, actual recoveries constitute a small proportion of the reduction in NPAs. In 2012, actual recoveries accounted for 34.4 per cent of NPA reduction, "upgradation" (from NPA status) for 34.5 per cent and compromises/write-offs for the remaining 31.1 per cent. In 2015, these figures stood at 32.6 per cent, 26 per cent and 41.5 per cent respectively. Write-offs are rising from already high levels.

This failure to recover money lent to top corporates, has been accompanied by an effort to sell-off assets to private Asset Reconstruction Corporations (ARCs), who could acquire NPAs at a negotiated discount. They make an upfront payment of as low as 5 per cent of the sums due, with the balance covered by security receipts accepted by the banks from the ARCs, which need to be redeemed only when the ARCs manage to sell the assets concerned. Thus, the ARCs were being contracted to recover a small percentage of the total NPA value, with their fee depending on the difference between the acquisition and sale price. The result has been that when the discount on NPAs sold by banks was sought to be reduced, the volume of NPAs sold have come down.

It is in this context that the Economic Survey's case for the creation of a Public Sector Asset Rehabilitation Agency (PARA) has to be assessed. In the Survey's view: "Cash flows in the large stressed companies have been deteriorating over the past few years, to the point where debt reductions of more than 50 percent will often be needed to restore viability. The only alternative would be to convert debt to equity, take over the companies, and **then sell them at a loss**" (emphasis added). So the point here is that instead of recapitalising the banks, the government should recapitalise the companies

at taxpayers' expense. The Finance Ministry's claim is that this is necessary because the companies cannot share any blame for their current position: "Without doubt, there are cases where debt repayment problems have been caused by diversion of funds. But the vast bulk of the problem has been caused by unexpected changes in the economic environment: timetables, exchange rates, and growth rate assumptions going wrong," the Survey argues.

This unabashed call for subsidising private sector losses comes at a time when the government claims it does not have enough money to recapitalise the banks. Government and RBI spokespersons have been recommending that public sector banks should sell new equity and dilute government stake to strengthen their capital base. But if banks are not recapitalised, there may not be many buyers for their equity. Meanwhile, the Finance Ministry is suggesting making transfers to the private sector through a roundabout scheme that helps write off their debt.

In the midst of this, newly appointed RBI Deputy Governor Viral Acharya, rumoured to have been hired for his advocacy of bad banks (a title he now says he dislikes), has floated a restructuring strategy which combines all the old ideas and has little new in it. It includes, restructuring of loans if the restructured asset is viable, sale of some assets with reasonable economic value to a Private Asset Management Company, sale of other assets to a (quasi-government?) National Asset Management Company, and recapitalisation of banks through sale of equity ('private capital raising'), asset sales and mergers. When a policy package claims to do a little bit of everything there is reason to be worried. That could be a way to implement what may be the worst elements of the package, with the rest being the smokescreen to conceal the core objective.

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