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Non-Performing Assets(NPAs)- Bold Corrective Initiatives : Critical Appraisal

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ABSTRACT

The Indian banking system has been confronted with a multitude of problems starting with high Gross Non-performing Assets (NPAs) ratios, low capital provisioning, and low profitability. During this period, the Indian banks, especially, Public Sector Banks (PSBs), were trounced to a level wherein they brought down the banking system of India to the poorest assets quality ratios globally. The RBI announced a plethora of regulatory measures to strengthen the India banking system, more specifically, to provide assets quality forbearance. The main objective of this paper is to provide a brief overview of the current situation of NPAs in India and the effect of the corrective measures taken by the Government of India through the Central Bank (RBI) from time to time.

Key Words: NPA, 4R's strategy, SARFAESI Act

Introduction

Financial markets play a crucial role in the advancement of contemporary economies. Until recently, the Indian stock markets were insufficiently developed to meet the capital requirements of the industrial sector. Consequently, the responsibility of industrialization and modernization of the economy was taken up by banks and other financial institutions in India. The public sector institutions, which constitute seventy percent of Indian banks, have collaborated with the government to promote welfare measures alongside sectoral developments. The resilience of the Indian banking sector is evident from its ability to withstand the Global Financial Crisis of 2008. However, the system's asset quality deteriorated in subsequent years, leading to mounting **Non-Performing Assets (NPAs)**. As per the Reserve Bank of India's directives, loans and advances granted to various categories of borrowers become NPAs when they fail to generate income for the bank, and the interest and/or principal loan amount remain overdue for more than 90 days. This has had a dampening effect on the investment climate in the country, resulting in a slowdown in Indian economic development. The Government of India, with the assistance

of the Reserve Bank of India, has been focusing on strengthening the health of banking institutions to enhance the prospects of economic growth.

What Led to the Rise of NPAs?

Causes leading to increase in Non-performing Assets (NPAs) in Indian banking system are partly intrinsic to the system itself while a few external factors, such as, fall in exports due to fall in global commodity prices are quite significant in aggravating the problem.

The problem of Non-performing Assets has, in fact, originated in the mid-2000s when Indian economy was performing well with a buoyant business outlook. Industries and business corporations expanded their projects based on extrapolation of their growth rates at the time and relatively satisfactory performance. Ease in availability of bank credit induced the corporate houses to finance their projects through bank credit rather than internal promoter equity. Thus, the irrational exuberance of the Indian economy and over enthusiastic financial markets led to a huge surge in investment plans of the non-financial corporate sector in India, especially the manufacturing sector. India's investment-GDP ratio in nominal terms moved from 26 per cent in Financial Year 2004 to 35 per cent in FY 2008.This was financed by the biggest credit boom in the history of India when both non-food credit and credit to the industry segment doubled in a short span of three years from the FYs 2005 to 2008.

The Indian banking system emerged relatively unscathed from the Global Financial Crisis (GFC). However, **the Report on Trend and Progress of Banking in India (RTP) in 2008-09** concluded that while the Indian banking system had largely withstood the pressure of GFC, it showed its vulnerability to the global economic slowdown and the near collapse of global trade in the aftermath. During this period, the RBI announced a plethora of regulatory measures to strengthen the Indian banking system, more specifically to provide **assets quality forbearance.** The main objective was to protect the banking system from the liquidity concerns of the borrowing firms having a negative impact on their repaying capacity. The repo-rate was almost doubled (from 4.7% to 8.5%) between September 2009 and December 2011. This raised the financing costs having an adverse impact on the investment climate of the country.

Unfortunately, the Indian economic growth stagnated following the Global Financial Crisis (GFC) of 2008. The export demand fell, and the projects funded by banks started under-performing. Consequently, the repaying capacity of the borrowers declined. Thus, developed a situation which is popularly known as the **Twin Balance Sheet problem** when the banking sector that funded the corporations(creditors) and the corporate sector that availed credit and had to repay them(debtors) have come under severe financial stress. The borrowers failed to maintain repayment schedule. By the period 2012-14, the financial stress precipitated into a crisis. During this period, the Indian banks, especially, Public Sector Banks (PSBs), were trounced to a level wherein they brought down the banking system of India to a level marked by the poorest assets quality ratios globally.

Further, depreciation of Indian rupee by more than 50% in a span of few years had a significant negative impact on the debt-servicing ability of the Indian corporate sector which was already reeling under the stress of heavy credit burden.

During the five-year period prior to 2015, banks resorted to restructuring of loans mostly to postpone the recognition of non-performance. By the year 2016, the restructured assets constituted more than 50% of the stressed assets of all the scheduled commercial banks, thus, causing a substantial deterioration of the loan portfolios. As a consequence, Indian banking system was confronted with a multitude of problems beginning with high Gross NPA ratios, low capital provisioning, low profitability. Consequently, the lending capacity of Indian banks almost collapsed impacting adversely the economic growth situation of India.

To make the matters worse, the promoters resorted to **'ever greening'** whereby fresh loans were granted to some promoters for payment of interest. This measure was aimed at postponing the recognition of non-performing assets. Further, frauds of high magnitude in the subsequent years have aggravated the problem.

The vicious circle was eventually broken with implementation of Asset Quality Review (AQR) in 2015. As banks were no longer able to hide their NPAs by using restructured asset classification, the implementation of the AQR led to the spike in NPAs. The proportion of NPAs in gross advances went up from about 2% in the year 2008 to over 10% in 2018, a few worst performing banks had the ratio more than 20%.

The factors that generated and subsequently aggravated the disease called stressed assets or NPAs in the Indian banking system can be categorised as under:

1. **Demand/trade shock due to Global Financial Crisis (GFC):**

The fact that Indian corporate sector could not mobilise equity finance from the market and depended heavily on external credit (bank finance) made Indian banks vulnerable. Too much of corporate funding indirectly affected the health (assets quality) of Indian banks. The GFC led to trade shock which can be assessed from the fact that the total trade of India (excluding oil) experienced an average annual growth rate of 23.53% during 2005-09 fell to (-)4.34% between 2008-09 and 2009-10. In other words, export demand slumped during this period. Further, the global commodity prices went up steeply which inflated the import bill to a considerable extent. As a result, the current account deficit of India widened. In sum, the GFC weakened the domestic economy, exerted tremendous pressure on domestic credit and deteriorated the quality of assets.

2. **The absence of bankruptcy law:**

The Indian banks allowed restructuring of corporate loans. The efforts towards forbearance and loan restructuring resulted in a mal alignment between banks and the corporate borrowers as the latter presented their balance sheets concealing their stressed assets.

3. **Public ownership of Banks:**

Public ownership of a large chunk of the Indian banking sector made them vulnerable to political pressures in discharging their lending operations. This has been one of the factors, if not the only factor, for developing stressed assets syndrome.

Former Governor of RBI, Dr. Urijit Patel, in his presentation at the Harvard University, growth of public sector banks in India is fraught with internal weaknesses like poor risk management techniques, high incidence of corruption and fraud running from branches to regional offices, a lower CRAR, a higher ratio of non-operating expenses as compared to Private sector banks and the list goes on. These negative factors are more than enough to erode the assets quality resulting in high net NPAs.

4. **Irrational exuberance during pre-GFC period:**

During this period, the financial growth outpaced the real economic growth. Indian economy registered consistently high annual GDP growth rates of around 7 to 8%. An exuberant corporate sector over estimated future performance causing rapid increase in credit growth compromising the asset quality. In the words of Dr. Raghuram Rajan, former Governor of the RBI," Too many loans were made to well-connected promoters who made a history of defaulting on their loans." Poor project management and risk monitoring along with global melt down caused high NPA levels.

5. **Weak capitalisation and Zombie lending:**

Public sector banks of India have weak capitalisation structure and they have the additional pressure of meeting Basel III capital norms. Zombie lending is the main cause of slow down.

Basel III is the regulatory norms for setting common standards for banks across different countries. The motive of Basel III norms is to enhance the regulation, supervision, and risk management in the banking industry.

i) Basel III norms were introduced in 2009 post the credit crisis of 2008. The first version of Basel III was published in late 2009. It gave a window period of three years to meet the Basel III requirements.
ii) Basel III norms have introduced strong capital ratios by increasing the minimum Tier 1 capital from 4% to 6%, and minimum Common Equity Tier 1 capital from 4% to 4.5%.

Globally, capitalisation of banks has gone up after the 2008 global financial crisis as banks have raised additional capital to strengthen their balance sheet.

The tier-1 capital ratio is the ratio of a bank's core capital — its paid-up equity capital, reserves, and surpluses (retained earnings) to the total risk-weighted assets. It is a key metric of a bank's financial strength. Higher the ratio, greater the bank's ability to absorb losses during periods of economic downturns and debt crisis.

Under the Basel-III norms, the banks in India must maintain a minimum tier-1 capital ratio of 7 per cent. The banks are also mandated to have a capital conservation buffer of 2.5 per cent of their risk-weighted assets.

In totality, the banks are required to maintain a minimum capital adequacy ratio of 11.5 percent by the end of March 2019, including 2 percent in tier-II capital (**Tier 2 capital** is the supplementary capital. It includes undisclosed reserves, general provisions, provisions against Non-performing Assets, cumulative non-redeemable preference shares, etc).

The public sector banks (PSBs) across the world have one of the lowest tier-I capital ratios. In FY18, the PSBs, of India, on average, reported a tier-I capital ratio of 8.4 per cent, against the global average of 14.1 per cent. In FY 2019-20,Indian listed banks reported a tier-1 capital ratio of 10.65 per— the lowest among the key emerging markets (EMs).

Experts feel that the lower capital ratios are mainly making the PSBs vulnerable to economic downturn.

“It’s true that capital ratio of the PSBs is on the lower side. It reflects poorly on their financial strength. Banks need to be well capitalised to absorb unforeseen losses, and fund their growth,” says Karthik Srinivasan, senior vice-president, Investment information and credit rating agency (ICRA).

Zombie Lending

Presenting details of the Economic Survey 2020-21 to media, the Chief Economic Advisor (CEA) Krishnamurthy Subramanian pointed out that extended regulatory forbearance after the Global Finance Crisis of 2008 gave way to irresponsible lending by banks to ‘zombies’ and caused damage to the economy.

In business parlance, **zombies** are those firms that are unable to meet interest obligations from their income. From a financial standpoint, these firms are obsolete but kept alive in account books by pumping new loans to facilitate payment of existing loans. Indian banks resorted to ever greening which aggravated the problem of NPAs. This can be assessed from the fact that the total credit disbursed to the top ten corporate borrowers was nearly 4 times the volume of farm loan waivers announced by ten state governments in the financial year 2017-18. Further, total loans to top ten corporate borrowers as of March,2015 accounted for 10-14% of the total bank credit and 27% of the total credit to industry.

Sector-wise contribution to NPA problem: A Chronological Analysis:

1. **FYs 2006 to 2011:**

High GDP growth rate led to a much higher rate of credit growth. Even when the over-all credit growth declined, the industrial credit increased. Post-2008, following GFC, the growth rate of profit margins of industrial sector declined, the corporates started defaulting loan payments, thus creating the problem of NPAs.

Sector	Percentage share of NPA
Telecom	1.33
Infrastructure	32.80
Metals	13.6
Textiles	6.90
Engineering	5.30
Processing	5.30

2. As industrial credit grew during 2006-11, the proportion of NPAs in industrial sector was much higher in comparison to other sectors; infrastructure sector being the highest contributor. MSME sector suffered greatly as credit flow to this sector was not adequate.

The Reserve Bank of India (RBI) reported that, bad assets in the system have been created by six sectors of the economy—infrastructure, metals, textiles, chemicals, engineering, and mining. Though, these sectors have only 30% of the credit share. The RBI, in its annual report for 2013-14, said gross non-performing assets in the system have grown to 4.1% in 2013-14 from 3.4% a year ago.

RBI report said these six specifically identified sectors contributed 36% of gross non-performing assets (NPAs), as against their 30% contribution to total advances. The gross NPA ratio for the **non-priority sector** grew to 4% as of March 2014 as against 3% in the preceding year, while the same for **priority sector** stood stable at 4.4%.The

report further observed that the non-priority sector has contributed more in the deterioration of the loan asset quality of the banking sector in recent years, however, the contribution of PSL (priority sector lending) loans to the overall bad loans narrowed to 36% as of 2013-14 from 40% in 2012-13.

In the year 2015, the RBI announced stringent guidelines for NPAs. The assets which were earlier accounted as standard assets came under the category of NPAs. As per the revised guidelines standard account on restructuring would be classified as NPA with certain exceptions. Thus, due to sheer accounting changes, there was a sharp increase in NPAs post-2015 (from 3.3% as of March 2013 to as high as 5.5-6.5% as of June,2015).

3. Impact of demonetisation: the RBI believed that banks were flushed with funds post-demonetisation but NPAs keep them away from lending. As per the RBI records, the gross bad loan ratio (GBLR) went up to 10.2% in 2018 as compared to 9.6% in March 2017. Despite the Reserve Bank of India announcing numerous restructuring schemes, bad loans have risen by 135% between 2015 to 2017.

4. In the financial year 2017-18 and in following years, ten state governments announced farm loan waivers totalling of Rs. 184,800 crores. In contrast, the total debt of top ten corporate borrowers alone was nearly four times that amount at Rs. 731, 000 crore (accounting for 10-14% of total bank credit) as of March 2015 and to top 12 industrial houses was nearly twice at Rs. 345 ,000crores.

Year	Gross NPAs(rupees in lakh crore)
March, 2017	8
March 2018	10.3

The share of NPAs of large borrowers have been increasing over time with a 40% share in total advances (lending by banks) and a 70% share in stressed assets (including NPAs, restructured loans, and assets written off by banks) at the end of March 2017. Further, top 12 corporate houses accounted for 25% of the total NPAs during the same period.

Sector-wise distribution of gross NPAs during 2017-18:

Sector	Gross NPAs(in percentage)
Large industries	20.99
SSIs	18.78
Other non-priority sectors	17.3
Medium industries	15.8
Agriculture	13.55
Other priority sectors	11.26
Public sector Units	2.44

NPA (%) of Private sector banks public sector banks for the period of 2015 to 2022

	Private Sector Banks					Public Sector Banks				
Year	HDFC	ICICI	AXIS	KOTAK	YES	SBI	PNB	BOB	Canara	BOI
2023	**1.12**	**2.82**	**2.12**	**1.76**	**2.17**	**2.75**	**8.70**	**3.83**	**5,35**	**7.31**
2022	**1.17**	**3.76**	**2.57**	**2.34**	**13.93**	**3.97**	**11.78**	**6.61**	**7.34**	**9.98**
2021	**1.33**	**5.6**	**3.54**	**3.25**	**15.41**	**4.98**	**14.12**	**8.87**	**8.93**	**13.77**
2020	**1.25**	**6.40**	**4.52**	**2.25**	**16.80**	**6.15**	**14.21**	**9.40**	**8.04**	**14.78**
2019	1.35	7.38	5.31	2.14	3.37	7.53	15.50	9.61	8.83	21.25
2018	1.28	9.90	6.79	2.22	1.33	10.91	18.38	12.26	11.84	23.46
2017	1.04	8.74	5.21	2.59	1.56	6.90	12.53	11.73	9.63	19.32
2016	1.10	5.82	1.71	2.36	0.77	6.50	12.90	11.93	9.40	12.66
2015	0.89	3.78	1.36	1.85	0.42	3.99	6.55	4.64	3.89	6.81

All these years the performance of private sector banks have been far better in comparison to the public sector banks. The NPAs showed an increasing trend in case of all institutions during the period 2015 to 2019.

The Reserve Bank of India (RBI) initiated an Asset Quality Review (AQR) in 2015, which revealed a high incidence of non-performing assets (NPAs) in banks.

1. As on June 30, 2018, the Gross NPAs of the banking sector stood at 11.52% of total assets. Net NPAs, however, were estimated to be about 6.21% by March 31, 2018.

   As per the RBI data the gross NPAs stood at INR 3,23,464 crores as on March 31, 2015 and increased to over INR 10.36 lakh crores figure by the end of 2017-18 fiscal on March 31. However, there is some respite as Gross NPAs of SCBs, which stood at INR10,36,187 crores on March 31, 2018, declined by INR 97, 996 crores to INR 9,38,191 crores as on June 30, 2019. This reduction in the gross NPAs is certainly attributed to efficient and time bound resolution process under the Code.
2. As per data reported by the RBI for domestic operations, data on bank-wise and category-wise NPAs of PSBs from loans granted to 'agriculture and allied activities', 'industry', 'retail loans-education', 'retail loans - housing', and 'other categories' stood at Rs 6,44,417 crore as on March 31, 2020. Among these five categories, the highest non-performing assets (NPAs) or bad loans in the 'industrial' sector stood at Rs 3,33,143 crore, followed by 'other categories' loan at Rs 1,77,275 crore, 'agriculture and allied activities' Rs 1,11,328 crore, 'housing loan' Rs 17,045 crore and 'education loan' at Rs 5,626 crore.
3. In response to the AQR results, the Minister stated that banks initiated transparent recognition, reclassifying standard restructured advances as NPAs, and providing for expected losses on such advances. As a result of this transparent recognition of advances with stress as NPAs, the gross NPA ratio of public sector banks (PSBs) rose from 5.0% in March 2015 to 14.6% in March 2018. The proportion of standard restructured advances reduced progressively from 7.0% to 0.8% during the same period. The increase in NPAs led to additional provisioning, which affected the profitability of banks, and a number of PSBs were brought under the prompt corrective action (PCA) framework of RBI. This had an adverse impact on the business growth of PSBs.

4. Minister of State for Finance and Corporate Affairs announced that: Banks' NPAs decline to Rs 8.08 lakh crore in September 2020 from Rs 10.36 lakh crore in March 2018. Government's strategy of recognition, resolution, recapitalisation, and reforms have resulted in decline of **NPAs** by Rs 2,27,388 crore to Rs 8,08,799 crore as on September 30, 2020.

   The Minister stated that the Government implemented a comprehensive 4R's strategy of Recognising NPAs transparently, Resolution and recovery, Recapitalising PSBs, and Reforms in the financial ecosystem. Major banking reforms undertaken by the Government over the last eight years addressed credit discipline, responsible lending, and improved governance, besides adoption of technology, amalgamation of banks, and maintaining general confidence of bankers, the Minister stated.

Policy Measures to Meet the Challenge

A. Earlier Measures:

The Government of India focused its attention on strengthening the banking sector of India from early 1990s when the Banking Commission report was submitted by the doyen of modern Indian banking, prof. Narasimham. On the basis of its recommendations, the government implemented different measures from time to time to improve the health of the Indian banks.

A cross-country study ranked India exceptionally low in terms of recovery prospects and time. Debts Recovery Tribunals (DRTs) were set up under the Recovery of Debts Due to Banks and Financial Institutions (RDDBFI) Act, 1993 to help banks and financial institutions recover their dues speedily without being subject to the lengthy procedures of usual civil courts.

A.1. Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI) Act:

The oldest measure in the 2000s was the **Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002** (**SARFAESI**) which allowed banks and other financial institutions to auction off residential or commercial properties (of Defaulter) to recover loans. The first asset reconstruction company (ARC) of India, ARCIL, was set up under this act. Criticisms arose that the provisions of SARFAESI Act, 2002 were being misused by the Banks in many cases. Thus, recovery was only a little over 13% of the amount at stake in 2013-14. The balance of power lay with big promoters who could play off one banker against another by choosing to

repay one but strategically defaulting on the other. In the scheme of things, the deck was stacked against banks who were not backed by the regulators in their efforts to recover outstanding loans given specifically to politically connected promoters.

Impact of SARFAESI measure

The RBI report observed that the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002, (SARFAESI) channel has emerged as a major mode of recovery in terms of the amount recovered as well as the recovery rate. Under SARFAESI, Rs 52,563 crore was recovered in 2019-20 against Rs 38,905 crore in 2018-19. With the applicability of the SARFAESI Act extended to co-operative banks, recovery through this channel is expected to gain further traction, the report said.

A.2. Debt Restructuring Measures:

In August 2001, the Reserve Bank of India (RBI) introduced the Corporate Debt Restructuring (CDR) mechanism which allowed syndicates or consortium of lenders to restructure the debt of corporate firms. The policy specifically targeted multiple banking accounts/syndication/consortium accounts of corporate borrowers with outstanding amounts exceeding Rs. 10 crores. Former Deputy Governor of RBI, Prof., Acharya pointed out that the assts restructured under CDR scheme were heavily stressed.

In August,2008 the RBI put in place the 'Special Regulatory Treatment' for the restructuring of debt. The rationale of the special regulatory treatment was to help with the GFC induced liquidity issues but not solvency issues. Despite the stated rationale, the 'asset quality' forbearance increasingly became a route to avoid appropriate recognition of NPAs sometimes referred to as 'extend and pretend'.

Dr. Rajan, then governor started an 'Asset Quality Review' (AQR) on the basis of which many loans hitherto classified as standard assets came under stressed assets (NPA) category. During this time, the Indian banking system showed an uptrend.

Some other measures implemented to improve asset quality of banks:

The Scheme for Sustainable Structuring of Stressed Assets (S4A): This scheme provided for bifurcation of the outstanding debt into sustainable debt and equity/quasi-equity instruments which are expected to provide upside to the lenders when the borrower turns around. This provided an incentive to capable, but over-leveraged promoters to perform and banks to continue to lend as the project is not deemed an NPA, if provided for adequately. The Strategic Debt Restructuring (SDR) scheme allowed for the conversion of debt into equity.

Many of these restructuring schemes have failed to produce any noticeable results mainly because banks used them to restructure the bad loans and not for reviving viable projects.

B. Recent Policy Measures to Address the Challenge:

B.1. Recapitalisation of PSBs:

The government of India attempted to solve the problem by strengthening the capital base of the PSBs. During the period between Financial Years 2015 to 2019 the Government of India resorted to a recapitalisation drive to the extent of Rs. 3.19 trillion, with the direct infusion of Rs. 2.5 trillion by itself. The balance Rs. 66,000 crores were to be mobilised by the PSBs themselves.

In August 2019, the Government of India again announced capital infusion to the PSBs to the extent of Rs. 55,000 crores. The beneficiary PSBs are: Punjab National Bank (Rs. 16,000 crores), Union Bank of India (Rs. 11,700crores), Bank of Baroda (Rs.7000 crores), Indian Bank (Rs. 2500 crores), Indian Overseas Bank (Rs.3800 crores), Central Bank (Rs. 3300 crores), U.Co. Bank (Rs 2100 crores), United Bank (Rs 1600 crores), Punjab and Sind Bank (Rs. 750 crore)

The Finance Ministry announced that government would infuse Rs 20,000 crore through recapitalisation bonds in four public sector banks during the **FY 2021-22** (Rs 5,500 crore to Punjab and Sind Bank in December 2020, and. Rs 14,500 crore through recapitalisation bonds in four public sector banks. The notification issued by the finance ministry said that government would infuse capital by issuing non-interest-bearing bonds to banks. The four banks include Central Bank of India(Rs 4,800 crore), Indian Overseas Bank(Rs 4,100 crore), Bank of India(Rs

3,000 crore) and UCO Bank(Rs 2,600). Out of the four PSBs three banks, namely, Indian Overseas Bank, Central Bank of India and UCO Bank are under Prompt Corrective Action (PCA).

B.2. Merger of Weak PSBs:

Prof. M. Narasimham, the former Governor of the RBI and the father of Indian banking reforms, in his report submitted to the government on 23rd April 1998. had called for banking sector mergers and acquisitions and had observed that the central Bank's role should be separated from being monetary authority to that of regulator of the banking sector.

The Committee recommended substantial dilution of government stakes in nationalized banks. The Committee also called for far reaching financial sector reforms. The Narasimham Committee on banking sector reforms favoured the merger of strong public sector banks and closure of some weaker banks if their rehabilitation was not possible. Thus, it favoured merger of strong banks as this would have a **"multiplier effect"** on industry. Mergers would have to yield benefits in terms of staff and branch network without which they would tie down managements with operational issues and merely distract attention from the real issues without giving any commensurate benefits.

India announced an extensive consolidation of state-owned banks that will see 10 of them being merged to form four bigger lenders to strengthen a sector struggling with a bad-loan clean-up and aimed at creating lenders of global scale. The government of India, in August,2019, announced **amalgamation of 10 public sector banks into four big banks.** After this the total number of Public Sector Banks in the country will come down to 12 from 27 banks in 2017.

Objectives:

- To widen capital base for lending and investments and broaden geographic footprint to operate. That way, you achieve your growth goals quicker.
- To consolidate and administer The larger operational infrastructure in an efficient manner, Financially, a larger bank has a lower aggregated risk profile since a larger number of similar-risk, complimentary loans decrease overall institutional risk.
- To fill product technological gaps.
- To enrich talent and better teamwork.

Thus, the government of India has implemented the bank merger policy in order to scale up operational skills, capital adequacy, operational cost efficiency that can result in improvement of profitability.

However, bank mergers may create negative impact on the customer confidence, employees and very often it poses management risks.

B.3. Pro-Cyclical capital Buffers:

A capital buffer is the mandatory capital that financial institutions are required to hold in addition to other minimum capital requirements. Regulations targeting the creation of adequate capital buffers are designed to reduce the procyclical nature of lending by promoting the creation of countercyclical buffers as per the Basel III regulatory reforms created by the Basel Committee on Banking Supervision. Capital buffers identified in Basel III reforms include countercyclical capital buffers that vary according to a percentage of risk-weighted assets, and capital conservation buffers, which are built up during the normal periods ,i.e., the period without any financial stress.

The concept of pro-cyclicality, when applied to the new capital requirements, may in principle be a little confusing. As is well known, one of the basic tenets of the new accord is to link capital requirements more closely to risks. For instance, in a downturn, when risks are more likely to materialise, capital requirements might increase. Thus, capital requirements and output growth will move in opposite directions. But if capital requirements increase, banks would have to reduce their loans and the subsequent credit squeeze would add to the downturn. **Capital** requirements are therefore said to be (likely to be) **pro-cyclical** because they might amplify the fluctuations of the business cycle.

A study conducted on ARE CAPITAL BUFFERS PRO-CYCLICAL. By Juan Juan Ayuso, Daniel Perez, Jesus Saurine in April 2002, Using annual data on Spanish banks from 1986 to 2000, found a fairly robust and significant negative relationship between the capital buffers and the business cycle.

Basel III capital regulations were implemented in Inia from 1st April,2013, in a phased manner, full implementation of it was achieved in March 2019. Basel norms demand a minimum Capital to Risk Weighted Asset Ratio (CRAR) of 9%. But the RBI prescribed it at 11.5% for Indian banks. Banks were required to hold a 2.5% mandatory capital conservation buffer apart from the minimum capital requirements. Indian banks are permitted to use these buffers for making specific provisions for NPAs during downturns. For this they need the prior approval of the RBI. These counter cyclical macro-prudential measures help arrest unreasonable credit growth in boom periods as experienced earlier.

Prompt Corrective Action (PCA):

Prompt Corrective Action is a regulatory measure introduced by the RBI to address the challenge of NPAs. The PCA framework is aimed at preventing further capital erosion and strengthen the banks with stressed assets to the point of resilience so that they can resume their normal operations as soon as possible. Under the PCA, the RBI's role is not just advisory in nature, but it can also push for changes in banks that the RBI may consider necessary to reduce the stress on the balance sheet of banks. The impact of the move is likely to be painful in the short run due to the disruption it could cause to the banks under PCA. However, over the longer run, it is likely to improve the faith of the people in the banking system and put greater pressure on banks to clean up their books at the earliest.

The RBI has delineated four criteria based on which a bank is subjected to regulatory action under PCA.

The first criterion is the Capital Adequacy Ratio (CAR). The CAR is a measure of how much equity and debt capital the bank has to cushion its asset book risk. Normally, the benchmark CAR is globally defined by the Bank for International Settlements (BIS), Basel in Switzerland. The PCA will start kicking in if the actual CAR of the bank falls more than 250 bps short of the modified CAR as defined by the RBI. That will be the first threshold. As the gap widens, higher thresholds will be initiated.

The second criterion is asset quality which is defined as the net Non-Performing Assets of the bank, net of provisions. The first threshold of PCA will be initiated by the RBI if the net NPAs of the bank crossed the 6% mark. In the case of IDBI Bank, the net NPAs had gone beyond 9% which triggers the 2nd threshold of PCA.

The third criterion is profitability. For the banks, the RBI considers the Return on Assets (ROA) as the benchmark for profitability. The RBI triggers the first threshold of PCA if the bank reports 2 years of consecutive negative ROA. 3 years of consecutive negative ROA will trigger the second threshold of PCA for the bank.

The fourth criterion is the total debt level or leverage, which measures the financial risk of the bank. The RBI will trigger Threshold 1 of the PCA when the total leverage crosses 25 times the Tier 1 Capital and will trigger Threshold 2 of the PCA when the total leverage crosses 28.5 times the Tier 1 Capital.

The Reserve Bank of India (RBI), operating under the Prompt Corrective Action (PCA) framework, has implemented specific and discretionary measures in response to banks surpassing certain thresholds. In 2017, a total of 11 banks were identified for regulatory action under PCA. However, as of September 2019, only four banks remained subject to PCA restrictions, namely IDBI Bank, Indian Overseas Bank (IOB), UCO Bank, and Central Bank of India.

IDBI Bank was placed under the PCA framework by the RBI in May 2017 due to breaches in capital adequacy, asset quality (with net non-performing assets exceeding 13% in March 2017), return on assets, and leverage ratio. Following improvements in these areas, IDBI Bank was removed from PCA regulations in 2021.

The three remaining banks under PCA, namely IOB, UCO Bank, and Central Bank of India, have reported net non-performing assets below the levels that trigger PCA regulation. The corrective action norms are utilized to control banks that have violated specific regulatory thresholds in terms of bad loans, capital adequacy, and profitability. While IOB was placed under PCA in 2015, the other two banks joined two years later.

Since then, the net non-performing asset ratios of all three banks have improved significantly due to substantial provisions made to cover bad loans. However, based on the criterion of proforma net non-performing assets,

Central Bank of India, with a ratio of 6.58%, does not meet the threshold for exiting PCA, as the RBI has set the threshold at 6%. Proforma bad loans indicate the percentage of assets that would have been classified as non-performing if not for a temporary halt on such classification imposed by a Supreme Court order on September 3rd. While IOB meets the criteria for net non-performing assets, UCO Bank, based in Kolkata, has not disclosed this information in the notes to its fiscal third-quarter financial results.

6.Insolvency and Bankruptcy Code (IBC):

Based on the Narasimham Committee Report, the Recovery of Debts due to Banks and Financial Institutions Act, 1993, was enacted and Debt Recovery Tribunals (DRTs) and Debt Recovery Appellate Tribunals (DRATs) were established. In the wake of enactment of the Insolvency and Bankruptcy Code (IBC) in the year 2016, the Act stands amended as the Recovery of Debts and Bankruptcy Act.

Resolution of stressed assets (NPAs and restructured assets) requires coordinated approach of the government, the Central Bank (RBI), and the lending bank itself. In 2016, with this objective, the Insolvency Bankruptcy Code was enacted which seeks to achieve resolution of distressed corporate debtors (CDs). As per the said Act, the entire process of recovery of debt was mandated to be over within a span of 18 months. It also facilitates liquidation in time bound manner under the supervision of National Company Law Tribunal (NCLT) if there is no resolution. The enactment of the IBC is considered as a second-generation economic reform. In the first-generation economic reform, India allowed liberal entry of firms in the market whereas in the second-generation economic reform through the code, India allows smoother exit of inefficient firms from the market.

The Code has set up a robust ecosystem in a short span of 3 years, where debtors and creditors are initiating resolution process under the provision of this code. In June 2017, RBI issued a circular for quick recovery and settlement of stressed assets for twelve of its largest defaulters. In the circular, it was mandatory to bring resolution plan for these defaulters within 180 days.

Non-performing assets (NPAs) recovered by scheduled commercial banks through the Insolvency and Bankruptcy Code (IBC) channel increased to about 61 per cent of the total amount recovered through various channels in 2019-20 against 56 per cent in 2018-19, according to latest Reserve Bank of India (RBI) data. according to RBI's "Report on Trend and Progress of Banking in India 2019-20." IBC, under which recovery is incidental to rescue of companies, remained the dominant mode of recovery. In absolute terms, of the total amount of Rs 1,72,565 crore recovered through various channels in 2019-20, IBC route accounted for Rs 1,05,773 crore. In 2018-19, of the total recovered amount of Rs 1,18,647 crore, the recovery via IBC channel was Rs 66,440 crore. RBI announced, "The government has suspended any fresh initiation of insolvency proceedings in respect of defaults arising for one year commencing March 25, 2020, to shield companies impacted by Covid-19."

Challenges for the IBC:

The recovery trends after the enactment of IBC have been encouraging, yet there are some challenges which are yet to be resolved. The biggest concern is that as per the Insolvency and Bankruptcy Board of India (IBBI) data over half of the cases closed under corporate insolvency resolution plan ended up in liquidation and only 14.93 per cent ended with a resolution plan approved. This data somewhere shows that this new system is running away from its intended purpose. The other challenge is that the largest NPAs are not yet resolved. Entire NPA in the resolution plan is not recovered, there is always some haircut. So far, the success of resolution under this new system has been achieved in only selected sector such as steel.

There is a need of differential treatment in handling the amount of NPAs. For example, higher NPAs should be resolved differently than the lower one. It is high time **to implement the recommendation of Sunil Mehta Committee**, which classify NPAs in three category and these categories should be handled separately either by asset management companies if the NPA amount is higher or by bank led resolution if the NPAs amount is lower. Also, the time limit to bring resolution plan should be proportionate to the amount of NPAs.

The Economic Survey, 2022-23 points out the following facts about Recovery of non-performing assets of scheduled commercial banks under the Insolvency and Bankruptcy Code compared to other debt recovery methods.

Progress achieved under the Insolvency and Bankruptcy Code:

Improvement of the business environment: Streamlining of the "exit" process

The implementation of the Insolvency and Bankruptcy Code (IBC) has effectively facilitated the resolution of distressed companies, thereby redirecting limited economic resources towards more productive utilization. Since its establishment in December 2016, a total of 5,893 Corporate Insolvency Resolution Processes (CIRPs) have been initiated as of the end of September 2022, with 67 percent of them successfully concluded. Among these, approximately 21 percent were resolved through appeals, reviews, or settlements, 19 percent were withdrawn, 46 percent resulted in liquidation orders, and 14 percent were approved as resolution plans. The Code also allows for a Corporate Debtor (CD) to voluntarily liquidate itself, provided certain conditions stipulated in the Code are met. As of the end of September 2022, a total of 1,351 corporate entities have initiated voluntary liquidation under the Code.

An analysis of the sectors involved reveals that 52 percent of the ongoing CIRPs pertain to the industrial sector, followed by 37 percent in the services sector as of September 2022. Furthermore, within the industrial sector, 74 percent of the initiated CIRPs originated from the manufacturing sector. Among these, the textile, basic metals, and food sectors accounted for 48 percent of the ongoing CIRPs. In the services sector, 60 percent of the ongoing CIRPs were related to real estate, renting, and business activities.

Behavioural Change: Restructuring Business Relationships

One of the significant and far-reaching effects of the Code has been the behavioural change it has brought about among debtors. The fear of losing control over the Corporate Debtor (CD) upon initiation of Corporate Insolvency Resolution Process (CIRP) has prompted thousands of debtors to settle their dues even before the commencement of insolvency proceedings. Until September 30, 2022, a total of 23,417 applications for initiation of CIRPs of CDs with underlying defaults of ₹7.3 lakh crore were disposed of before their admission into CIRP.

It is noteworthy that 69 per cent of the distressed assets were successfully rescued, with a realisation value of approximately 178 per cent of the liquidation value. Until September 30, 2022, a total of 553 CIRPs have been resolved. Despite the low value of the distressed firms at the outset, the Code has been successful in rescuing 69 per cent of the distressed assets. In terms of value realisation for initiators of CIRPs, including Financial Creditors, Operational Creditors, and Corporate Debtors, the resolution plans have realised ₹2.4 lakh crore, which is 177.6 per cent of the liquidation value and 841 per cent of the fair value of the 553 CDs rescued. Furthermore, the realisation by financial creditors under resolution plans in comparison to liquidation value was 201 per cent, while the realisation by them was 33 per cent of their claims.

92 percent of the value realized through the liquidation process was obtained from 1807 CDs as of September 2022. These CDs had assets valued at less than 8 percent of the total claim amount. However, a majority of the CIRPs that ended in liquidation (1349 out of 1774 for which data is available) were previously under the jurisdiction of the Board for Industrial and Financial Reconstruction (BIFR) and/or are no longer operational. The economic value of most of the corporate debtors that ended in liquidation had already been significantly depleted before they entered the CIRP. 429 CDs have been fully liquidated. The Code has facilitated the realization of 92 percent of the value through the liquidation of these companies.

Non-Performing Assets (NPAs): IBC attains the most substantial recuperation rate for Scheduled Commercial Banks

According to data from the Reserve Bank of India, in the fiscal year 2022, Scheduled Commercial Banks (SCBs) have recovered the highest amount through the Insolvency and Bankruptcy Code (IBC) compared to other channels such as Lok Adalat, SARFAESI Act, and Debt Recovery Tribunals (DRTs) during this period.

In a resolution model like the IBC, which is based on public auctions, the extent of the haircut represents the discount that the market demands for acquiring the distressed entity as a going concern. Due to significant value destruction that may have already occurred in these assets, comparing the realized value with the admitted claims may not be a reasonable indicator of the effectiveness of the resolution process. Furthermore, the rate of recovery depends on various factors, including the overall macroeconomic environment, perceived growth prospects of the entity and its sector, and the extent of erosion in the intrinsic value of the entity. As a comprehensive recovery gains momentum, these factors are likely to become favorable for financial resolution.

Amount recovered by SCBs through various channels (Amount in ₹ crore)

Recovery Channel	Amount recovered during the year *				
	2017-18	2018-19	2019-2020	2020-2021	2021-2022 (P)
Lok Adalats	1,811	2,750	4,211	1,119	2,777
DRTs	7,235	10,552	9,986	8,113	12,114
SARFAESI Act	26,380	38,905	34,283	27,686	27,349
IBC	4,926	66,440	1,04,117	27,311	47,421
Total	40,352	1,18,647	1,52,597	64,229	89,661

Source: Off-site returns, RBI and IBBI

Note: P: Provisional, DRTs stand for Debt Recovery Tribunals

*: Refers to the amount recovered during the given year, which could be with reference to the cases referred during the given year as well as during the earlier years.

7. Remedy for NPAs in the Union Budget 2021-22: Bad bank/ Asset Management Company and Asset Reconstruction Company:

The RBI issued a warning in its **Financial Stability Report** that Gross NPAs on bank balance sheets could rise from 7.5% in September,2020 to 13.5% in September,2021 in the base line scenario. The RBI projects that in a medium stress scenario, Gross NPAs of all banks may rise from 7.5% in September, 2020to 14.1% by September,2021. In case the macroeconomic situation worsens; the GNPAs of banks may rise to at least 14.8% by September,2021, a two-decade high level.

So, with commercial banks set to witness a spike in NPAs, or bad loans, in the wake of the contraction in the economy as a result of the Covid-19 pandemic, Reserve Bank of India (RBI) Governor Shaktikanta Das recently agreed to look at the proposal for the creation of a bad bank.

A similar idea was announced by the government of India in the year 2018 in the name of "Project Sashakt" for solving the problem of bad loans emanating from PSBs. But the idea was subsequently abandoned.

A bad bank conveys the impression that it will function as a bank but has bad assets to start with. Technically, a bad bank is an asset reconstruction company (ARC) or an asset management company that takes over the bad loans of commercial banks, manages them and finally recovers the money over a period. The bad bank is not involved in lending and taking deposits, but helps commercial banks clean up their balance sheets and resolve bad loans. The takeover of bad loans is normally below the book value of the loan and the bad bank tries to recover as much as possible subsequently.

Earlier former RBI Governor Raghuram Rajan had opposed the idea of setting up a bad bank in which banks hold a majority stakes.

Viral Acharya, when he was the RBI Deputy Governor, had said it would be better to limit the objective of these asset management companies to the orderly resolution of stressed assets, followed by a graceful exit. Acharya suggested two models to solve the problem of stressed assets. The first is a private asset management company (PAMC), which is said to be suitable for stressed sectors where the assets are likely to have an economic value in the short run, with moderate levels of debt forgiveness. The second model is the National Asset Management Company (NAMC), which would be necessary for sectors where the problem is not just one of excess capacity but possibly also of economically unviable assets in the short to medium terms.

Finance Minister in her Budget speech 2022 announced setting up of a bad bank, which will "consolidate and take over the existing stressed debt and then manage and dispose of the assets to Alternate Investment Funds and other potential investors for eventual value realisation". The Bad Bank or National Asset Reconstruction Company Limited (NARCL), as it is called now, is set to commence operations from June. According to a PTI report, banks are likely to transfer about 80 large NPA accounts, each with a size of over Rs 500 crore, to NARCL for resolution. The new entity is being created in collaboration with both public and private sector banks.

"This is expected to be more efficient in recovery as it will step into the shoes of multiple lenders, who currently have different compulsions when it comes to resolving a bad loan," says Indian Banks' Association CEO Sunil Mehta.

NARCL will pay up to 15% of the agreed value for the loans in cash and the remaining 85% in government-guaranteed security receipts. The government guarantee would be invoked if there is a loss against the threshold value. Loans classified as fraud cannot be sold to NARCL.

As per the RBI annual report, about Rs 1.9 lakh crore of loans have been classified as fraud as on March 2020. Gross NPAs of banks which stood at Rs 8.96 lakh crore in 2018 declined to Rs 5.70 lakh crore in December 2020. But the pandemic impact is expected to reverse the gains made through various measures, including technical write-offs, recapitalisation, recovery. As the impact of relief measures, including a moratorium on loan repayment, wanes off, gross NPAs of banks is likely to rise to 9.6-9.7% by March 31, 2021, states a report by Icra Ratings. GNPAs may worsen further to 9.9-10.2% by March 31, 2022.

Asset reconstruction companies play an important role in the resolution of stressed assets. Their potential, however, is yet to be fully realised," RBI Governor Shaktikanta Das had said. There are 28 ARCs registered with the RBI as on January 2021.

CP Chandrasekhar, who taught at the JNU, writes how the almost two-decade long effort to use ARCs has not yielded expected results. "How effective the ARC route to sustainable NPA reduction would depend on: (i) the actual volume of NPAs that are absorbed; (ii) the average discount at which NPAs are absorbed; and (iii) the success with disposal. There remains the issue of from where the ARC/AMC would raise the capital required to acquire the loss-making assets from the banks. This might require another sleight of hand," he writes in the EPW (May 15).

According to prof. A. S. Ramasastri, former Chief-General Manager-in-charge,

"I don't think it is appropriate to call the proposed entity as bad bank. The right terminology should be either Asset Reconstruction Company or Asset Management Company. It is good that it is now formally referred to as **National Asset Reconstruction Company (NARC)**. As far as the current activity around it is concerned, it is the need of the hour in view of the alarming rise in NPAs and its forecasts in the near future. Gross NPAs, which are already as high as 7-8% at present, are predicted to go up to 15-16% by September 2021".

He further observed that: NARC is expected to be more efficient in recovery as it will step into the shoes of multiple lenders, who currently have different compulsions when it comes to resolving a bad loan. It will take over identified bad loans of lenders and its biggest advantage is the aggregation of the bad loans. The new entity is being created as a collaboration among public and private sector banks. The efforts are coordinated by the Indian Banks' Association. They are backed by the government. Besides, there is a tacit concurrence from the RBI. The distinct advantage of NARC in comparison to separate AMCs is that it could reduce information asymmetries regarding borrower details.

In August this year, RBI set up a committee headed by K.V. Kamath on restructuring of loans impacted by the Covid-19 pandemic. The Committee was tasked to recommend parameters for one-time restructuring of corporate loans. The Committee submitted its report on 4th September,2020.

Recommendations of Kamath Committee

The five financial parameters specified by the committee are indicators of leverage, liquidity, and debt serviceability. A ceiling or floor has been mandated to decide the eligibility of a borrower while considering loan recast.

One of the parameters is debt service coverage ratio (DSCR), which indicates the debt servicing capacity of the borrower. DSCR is defined as addition of net cash accruals for the relevant year, along with interest and finance charges, divided by addition of current portion of long-term debt with interest and finance charges. The committee has recommended that the current ratio (current assets divided by current liabilities, reflecting the liquidity position of the company) and DSCR in all eligible cases shall be 1.0 and above, and average DSCR shall be 1.2 and above. This means the cash flow of the borrowers needs to be more than what is required to service debt. Bankers say as a result, not many companies will be eligible for loan restructuring.

The RBI, in its press release on 4th September,2020, announced acceptance of the recommendations of the Committee

The Kamath panel said that companies in sectors such as retail, wholesale trade, roads and textiles are facing stress due to the pandemic. Sectors that have been under stress even before the pandemic include NBFCs, power, steel, real estate, and construction. The panel felt that setting up a national organisation can benefit immensely. There is a definite scope for a well-capitalised and well-designed entity in the Indian ARC industry, and such an entity will strengthen the asset resolution mechanism. To take the process further, the RBI has set up a committee to review the working of ARCs and recommend measures for enabling such entities to meet the growing requirements of the financial sector.

For the successful operation of NARC/ARCs, IBC and other regulatory measures they need the following:

Government backing, legislative changes, regulatory guidelines, quick recovery process and support from all stakeholders. If all the above are in place, NARC is likely to succeed. Its success is in the best interest of banks, borrowers, investors, and all economic entities.

Concluding Observations and Suggestions:

- Since the initiation of banking sector reforms in early 1990s, various measures were adopted by the Government to arrest the growth of stressed or non-performing assets of Indian banks, especially public sector banks.
- As of July 31, 2022, there were 29 ARCs registered with the RBI to participate in the management of NPAs. It is a specialized financial institution that buys the Non Performing Assets (NPAs) from banks and financial institutions so that they can clean up their balance sheets. This helps banks to concentrate in normal banking activities. Banks rather than going after the defaulters by wasting their time and effort, can sell the bad assets to the ARCs at a mutually agreed value.

- The RBI has been issuing notifications from time to time on prudential norms, reconstruction and rehabilitation of stressed accounts, prevention of slippage of NPAs, and alternative measures of dealing with stressed assets. As per the reports there is a consistent improvement of NPA ratio of Private as well as public sector banks since 2022. The RBI report presenting the projections for September.2021 is a clear indication of this.

Suggestions:

- The approach of banks and financial institutions should be on micro-focusing of the problem. First the nature of stress(sickness) should be ascertained. It can be:
    a. weak or faulty inception or the institution is born sick,
    b. operational sickness or sickness acquired due to faulty loan or banking policies,
    c. sickness thrusted on it through exogenous forces/factors.

  Basing on the nature of sickness, corrective or effective remedial measures can be taken. The policy measures need to be framed considering the macroeconomic environment of the economy, market environment, and global economic situation. For their effective implementation, a concerted action is required by all the stakeholders of banking and financial institutions.
- As per the observations made by experts including the former governors, one of The RBI of the major factors leading to the problem of NPAs of public sector banks of India has been unprofessional attitude of the banking personnel, especially those engaged in sanctioning and disbursement of loans. Particularly, persons with political affiliations or connections could easily avail loans irrespective of the feasibility of their projects. Consequently, the recovery/ repayment schedule could not be effectively monitored.

  So, what is of prime importance to achieve the objective of eliminating NPAs is to build a human resource base for public sector banks that is efficient, dynamic, and out and out professional in discharging banking operations. To be precise, it should possess the following qualities:

  i. Strong service orientation with the strength to adhere to banking norms even under challenging situations.
  ii. Analytic skills,

iii. Talent to assess and foresee the impending problems, to undertake trend analysis so that logical approach to the problem can be made.
iv. Capacity to take timely decisions,
v. An intuitive/out of box thinking,

Above all, banks need to be empowered to create a robust leadership that can inspire the workforce to profess ideas that can meet the challenges like NPAs. Public recognition, rewards and pecuniary benefits can work as stimulants for the workforce to give their best.

Banking business is a broad economic function that integrates the general public (the savers/depositors), the borrowers and the investors and thereby influences the demand and supply chains of the economy. It is an integral part of the macroeconomic setup of the country having its impact on monetary and real sectors. So, what is needed is, understanding of the banking business in its entirety and perspective.

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