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India's Nonperforming Assets: A Lurking Crisis

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- **India's financial institutions have a rapidly rising book of bad loans, known as nonperforming assets (NPAs).**
- **The rise in NPAs** is due to mismanaged lending practices of banks, a surge in lending, and investment-related policy inertia in a low-growth, high-inflation environment.
- **The Finance Ministry** has dedicated approximately \$2 billion to recapitalize public-sector banks, while the **Reserve Bank of India (RBI)** has designed a new regulatory framework for the early detection and resolution of these assets.
- **In order to reduce the NPA ratio**, assets are typically recovered or restructured. Both procedures require additional legislation to expedite the process.
- **Further steps need to be taken** such as deepening the bond market, strengthening the institutional architecture behind lending, and improving the credit-exposure monitoring processes in order to prevent asset quality from deteriorating again.

Asset quality in India's banks has deteriorated sharply and if not tackled promptly poses a systemic risk to the banking system—and by extension the Indian economy. A high proportion of nonperforming assets (NPAs) steadily erodes the capital base of a bank, impinging on the ability of banks to raise fresh capital and continue lending for investment activities. Indeed, the spillover impact from banking crises to the real economy is all too familiar, evinced by the subprime mortgage crisis in the United States. However, despite this risk, the issue is not garnering sufficient attention outside the banking industry.

What Has Led to the Rise in NPAs?

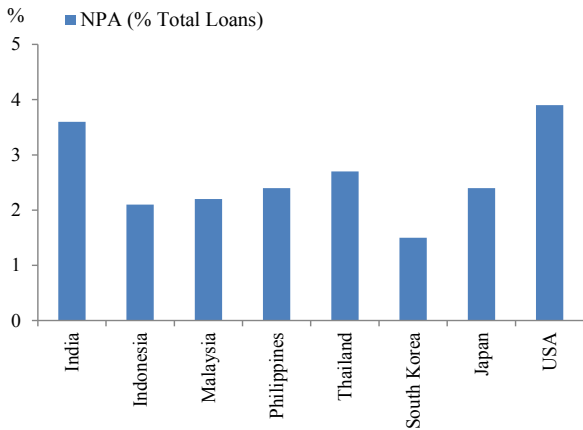
The NPA ratios in India have risen sharply and now significantly exceed regional averages. Between 2009 and 2012, NPAs to total loan ratio in India rose from 2.3 percent to 3.6 percent and is projected to reach 5 percent by the end of 2014.¹ In contrast, the Southeast Asian average² for 2012 is just 2.2 percent, with Japan's ratio at 2.4 percent (see figure 1).³ A number of factors have lent to this increase in NPAs, including investment-related policy logjams in a low-growth, high-inflation (stagflation) environment and poor lending practices of several banks.

¹ Reserve Bank of India (RBI), "Report on Trend and Progress of Banking in India 2008-09," 337, http://rbidocs.rbi.org.in/rdocs/Publications/PDFs/RTP0809PRD_Full.pdf; RBI, "Report on Trend and Progress of Banking in India 2012-13," 66, http://rbidocs.rbi.org.in/rdocs/Publications/PDFs/0RTP21112013_F.pdf; Associated Chambers of Commerce and Industry of India (ASSOCHAM), "Gross NPAs of Banks to touch 5 percent by March-end," January 16, 2014, <http://www.assochem.org/prels/shownews-archive.php?id=4348>.

² South Korea, Indonesia, Malaysia, Thailand, Philippines.

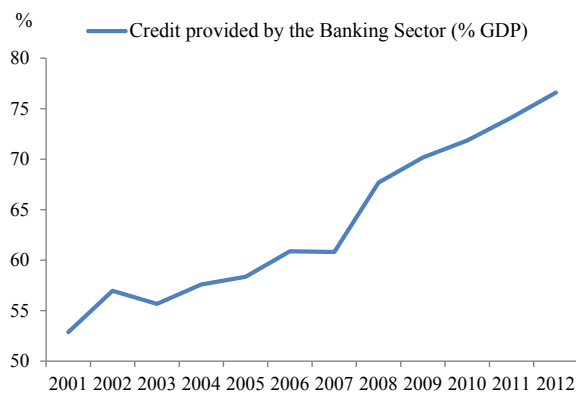
³ World Bank, "Bank Nonperforming Loans to Gross Loans," <http://data.worldbank.org/indicator/FB.AST.NPER.ZS>.

Figure 1: India’s NPAs exceed regional averages, but is lower than the NPA ratio in USA



Source: World Bank

Figure 2: Rising credit-to-GDP ratio in India



Source: World Bank

A surge⁴ in lending (see figure 2) provided easy access to credit, which drove up prices. However, this was not followed by a concomitant rise in growth.⁵ Despite this economic slowdown, the central bank resorted to hiking interest rates to combat inflation. This unusual stagflationary cycle compounded the cost of debt servicing for borrowers. The rising prices not only eroded the disposable income of borrowers, but the economic slump also reduced the market value of assets, impeding the repayment capacity of borrowers.

In particular, according to a recent study, conglomerates⁶ significantly increased their leverage ratios⁷ in 2012 and 2013. It is striking that the 10 corporate groups under examination were heavily involved in the infrastructure sector, the largest contributor of NPAs under industrial credit.⁸ Policy gridlock led to several stalled projects in this sector, which strained revenue generation for corporations.⁹ This further transmitted to banks exposed to these corporations and intensified the deterioration in bank asset quality (see figure 3).¹⁰

⁴ This surge was driven by investors diverting funds to higher-yielding emerging market economies like India, the RBI slashing reserve requirements at banks to make latent cash stocks available, and a spurt in government lending programs.

⁵ Supply bottlenecks in investment projects and policy uncertainty led to a slowdown in growth.

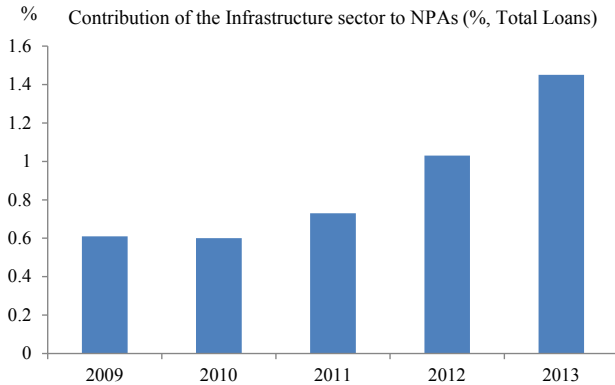
⁶ The 10 corporate groups in this study account for 2 percent of total loans in India.

⁷ Credit Suisse, “India Financial Sector: House of debt—revisited,” August 13, 2013, 1, https://doc.research-and-analytics.csfb.com/docView?language=ENG&source=emfromsendlink&format=PDF&document_id=1021449371&extdocid=1021449371_1_eng_pdf&serialid=9IEtj9tC9wxAGa5r2NuYSCyQ3AtHVhY88a0%2bhKfpy3E%3d

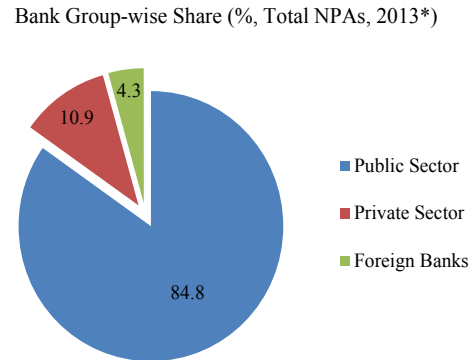
⁸ Other types of credit include retail credit and priority sector credit (e.g., agriculture).

⁹ Dinesh Unnikrishnan, “Banks face bad loan threat as infrastructure projects get stuck,” *Live Mint*, February 15, 2013, <http://www.livemint.com/Industry/pbkwDZNONTIrrXIWpdehQJ/Banks-face-bad-loan-threat-as-infra-projects-get-stuck.html>; IMF, “India: 2014 Article IV Consultation,” IMF Country Report No. 14/57, February 2014, 4, <http://www.imf.org/external/pubs/ft/scr/2014/cr1457.pdf>.

¹⁰ Avinash Celestine, “India Inc Sitting on Debt Bomb,” *Economic Times*, August 25, 2013, http://articles.economictimes.indiatimes.com/2013-08-25/news/41446044_1_private-banks-public-sector-banks-deputy-governor-kc-chakrabarty.

Figure 3: Infrastructure sector's rising contribution to the NPA ratio

Source: RBI, * Data as of September 2013

Figure 4: Public sector banks contributed to the bulk of NPAs

Source: RBI, * Data as of September 2013

The onus, however, does not lie with the government alone. The RBI drew attention to the inadequate credit appraisal processes of banks, where insufficient discipline and oversight was enforced over companies.¹¹ In one instance, a bank lent several million dollars to a project years after its completion.¹² Further, banks tended to favor certain applicants over others owing to political pressure, while also racking up vast exposures to government lending schemes.¹³

Tackling Rising NPAs

In order to reduce the NPA ratio, assets are typically recovered or restructured. However, India's lack of a comprehensive bankruptcy law makes asset recovery extremely difficult. As such, borrowers usually resort to legal injunctions—relying on an over-burdened court system to delay the process.¹⁴ Only 22 percent of bad loans were retrieved in 2013 compared to 31 percent in 2011.¹⁵ Recognizing the problem, the government initiated an inquiry into the top 30 NPA accounts of the public sector banks (PSBs), the single largest source of NPAs (see figure 4).¹⁶ Additionally, the Finance Ministry dedicated approximately \$2 billion to recapitalize these banks, while the RBI designed a new regulatory framework for the early detection and resolution of distressed assets, effective from April 1 2014.¹⁷ Along with these steps, the timely implementation of the national

¹¹ RBI, "Report on Trend and Progress of Banking in India 2012-13," 32–38.

¹² "Banks Slammed for Reckless Lending to Infrastructure, Power sectors," *Financial Express*, September 11, 2013, <http://www.financialexpress.com/news/banks-slammed-for-reckless-lending-to-infra-power-sectors/1167243>.

¹³ Henry Sender, "Bad Bank Loans behind much of India's corporate woes," *Financial Times*, December 19, 2013, <http://www.ft.com/cms/s/0/1e051518-6885-11e3-996a-00144feabdc0.html?siteedition=uk#axzz2uMRLwh01>; Manish Basu, "Political Interference a Challenge for Recovery," *Live Mint*, February 20, 2014, <http://www.livemint.com/Companies/vAXxxKhu0aAXUiwkvVWQ90/Political-interference-a-challenge-for-recovery-United-Bank.html>.

¹⁴ Anita Bhoir, "Recovery of Bad Loans Still a Struggle," *Economic Times*, August 28, 2013, http://articles.economictimes.indiatimes.com/2013-08-28/news/41538998_1_bad-loans-loan-recovery-drt.

¹⁵ RBI, "Report on Trend and Progress of Banking in India 2012-13," 69; RBI, "Report on Trend and Progress of Banking in India 2011-12," 69, <http://rbidocs.rbi.org.in/rdocs/Publications/PDFs/OTPB021112FLS.pdf>.

¹⁶ TNN, "CBI Starts Probe into 30 Big Loan Defaulters," *Times of India*, August 22, 2013, <http://timesofindia.indiatimes.com/india/CBI-starts-probe-into-30-big-loan-defaulters/articleshow/21965876.cms?referral=PM>; RBI, "Report on Trend and Progress of Banking in India 2012-13," 66.

¹⁷ ENS, "PSU Banks Get Rs. 11,200 crore to Shore Up Tier-I Capital," *Indian Express*, February 18, 2014, <http://indianexpress.com/article/business/banking-and-finance/psu-banks-get-r11200-crore-to-shore-up-tier-i-capital/>;

company law tribunal aimed at rehabilitating sick companies could play an important role in fast-tracking asset recovery.

In terms of restructuring, several banks attempted to window-dress their NPA accounts using restructured assets.¹⁸ The ratio of restructured assets to total advances in 2012 nearly doubled to 8 percent from 2009.¹⁹ Such heavy reliance on restructuring could have implications on asset quality if a large proportion of these assets turn into bad loans. In order to prevent such an outcome, the central bank tightened restructuring norms, which included raising capital requirements.²⁰ Further, the comparative lack of asset reconstruction companies (ARCs) in India impedes the process of price discovery between banks and the ARCs. In order to deepen this market to adequately compensate banks, the sale of assets between ARCs must be permitted.²¹

While the above measures are an important first step in addressing the problem of rising NPAs, additional steps must be taken in order to strengthen the institutional architecture behind the process of lending. PSBs typically mobilize resources from deposits, but lending to infrastructure projects involves long gestation periods. A deep bond market and financial institutions focused on infrastructure projects are better equipped to deal with this type of investment, and attention needs to be focused on improving them. Out of the nine development financial institutions regulated by RBI,²² two have converted to banks and three others have applied for banking licenses.²³ New institutions need to take their place in order to provide funds for long-term projects. Further, allowing insurance funds to invest in corporate debt, similar to pension fund provisioning, would also help in taking the pressure off of banks to fill this gap.²⁴ The development of a liquid corporate debt market would facilitate the growth of potentially large investors such as mutual funds and financial institutions.

In terms of borrowers, if India is to stem the rise of NPAs, it is not sufficient simply to pursue recalcitrant borrowers. Officials also need to take punitive action against banks' lending under political pressure. To improve the due diligence process, the central bank is already taking steps toward devising a post-loan-sanction monitoring system that pools and scrutinizes common exposures across banks. This would enable banks to monitor shared borrowers with considerable leverage and keep track of debtors with a poor credit record. Finally, the Credit Information Bureau India Limited (CIBIL) and the three private credit information companies—which keep a credit record of banks' borrowers—need to grow their base of institutions to include nonbank financial companies, microfinance institutions, and unregistered sources. This would assist banks in casting a wider net to monitor borrowers and streamline lending to dubious parties. An RBI committee tasked

RBI, "Discussion Paper on Early Recognition of Financial Distress," <http://www.rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=715>.

¹⁸ ET Bureau, "RBI Probs Banks for Recovery of Bad Loans," *Economic Times*, November 18, 2013, http://articles.economictimes.indiatimes.com/2013-11-18/news/44202007_1_governor-raghuram-rajan-bad-loans-loan-restructuring.

¹⁹ RBI, "Financial Stability Report—December 2013," 30, http://www.rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=30280.

²⁰ RBI, "Review of Prudential Guidelines on Restructuring of Advances by Banks and Financial Institutions," May 2013, <http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=8008&Mode=0>.

²¹ Tamal Bandyopadhyay, "Reconstructing asset reconstruction firms," *Live Mint*, October 9, 2011, <http://www.livemint.com/Opinion/dNMY05fLnJwWQuacrsAQEN/Reconstructing-asset-reconstruction-firms.html>.

²² Institutions such as Power Finance Corp., Indian Railway Finance Corp., and India Infrastructure Finance Company Ltd. are not regulated by RBI.

²³ RBI, "Report of the Working Group on Development Financial Institutions," May 2004, 19, <http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/53674.pdf>; Malvika Joshi, "Bank License: Jalan Panel May be Ready to Make Final Suggestions by Month-End," *Live Mint*, February 14, 2014, <http://www.livemint.com/Industry/dXL9WknNoPPODPheoqOHCL/Jalan-panel-may-be-ready-to-make-final-suggestions-by-month.html>.

²⁴ "India Allows Greater Flexibility in Pension Fund Investments," Reuters, December 4, 2013, <http://in.reuters.com/article/2013/12/04/india-pension-idINDEE9B305820131204>.

with expanding the use of credit information systems has recently come out with a set of draft recommendations.²⁵

To avert the damaging effects of a banking crisis to the rest of the economy, as in the case of the United States, internal processes of banks in India need revision. Not only do poor lending practices need to be checked, the government needs to step up its game in implementing laws to speed up the process of NPA resolution. More importantly, for growth to return to 7–8 percent, it is imperative that the private sector begin investing again, which is unviable without support from healthy banks. A sound banking system is a necessary requirement for the desired growth trajectory. The Reserve Bank of India is actively working to avoid a wider crisis, and the next government must be prepared to put its energies into this effort.

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²⁵ RBI, "Report of the Committee to Recommend Data Format for Furnishing of Credit Information to Credit Information Companies (CICs)," March 2014, <http://www.rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=763>.