The NPA crisis: genesis and resolution

The financial crisis that originated in the United States in 2008 laid the foundation for much of today's non-performing loans plaguing the Indian banking sector. Tracing the history of the crisis, lax underwriting standards and risky behavior at Wall Street, abrogation of the Glass Steagall Act which mandated a Chinese Wall between investment banking and commercial banking, explosion in financial engineering in the form of Credit Default Swaps, CDO's etc., and "originate and sell" strategy by banks through securitization were some of the contributing factors; not in the least was the role played by Credit Rating Agencies in precipitating the crisis. Analysts from the agencies privately expressed skepticism about the fate of the subprime securities that they were tasked to rate, but went ahead with a AAA rating, to win and stay in business giving a false sense of comfort to the buyers.

When fault lines emerged in the markets in early 2008, and the securities firm Bear Stearns faced a run, the US Government arranged for its bail out through JP Morgan Chase Bank. But for reasons best known to him, Henry "Hank" Paulson US Treasury Secretary, chose to let Lehman Brothers with its trillion dollar balance sheet fail. The markets seized up, banks refused to lend to each other in the overnight money markets, the commercial paper market for corporates froze and money market funds which were known to never "break the buck", did so at the peak of the crisis.

Next in line to reach the verge of collapse was the insurer AIG with its trillion dollar balance sheet and a massive exposure to subprime securities which it underwrote through Credit Default Swaps. Having belatedly realized its folly in the Lehman Brothers episode, the US government stepped in with an unprecedented bailout of USD 180 billion for AIG. Through the Troubled Asset Relief program or TARP, banks accepted capital from the US government in its bid to restore confidence in the banking and financial system. The US Federal Reserve brought its Federal Funds Rate to zero and unleashed a wave a liquidity through the program known as Quantitative Easing.

Cut over to India, with its economy growing at more than 9.5 pct. pre crisis, and believing that its growth rate was still below potential. The financial crisis emanating in the US reached the Indian shores and impacted the markets in India as well. Money markets nearly seized up and rates went through the roof. Foreign investors stampeded for the exits. The equity market fell by over 50 pct. from its peak. In the first half of 2008-9 more than Rs 50,000 crores flew out of debt mutual funds. The central bank stepped in and infused liquidity through a special 14 day Repo and other liquidity measures for mutual funds through banks.

The crisis in the Indian markets took a toll on the economy. GDP growth fell to 6.72 pct. in 2008-09 from 9.32 pct. in the previous year. The government sought to revive "animal spirits" in the economy and get back to pre-crisis growth rates to prove to the world that India was immune to the impact of the financial crisis exported by the US. Public sector banks were under tremendous pressure to lend to steel, power and infrastructure companies in big ticket loan transactions. This was often backed up by project reports prepared by consultants and others that provided a rosy picture of demand and supply. A period of euphoric lending followed with GDP growth rate rebounding back to levels seen before the financial crisis.

And then came the NPA day of reckoning. When the tide finally turned, most of the old guard like the Tata and Birla group companies who had their fair share of woes, never defaulted in the most adverse of conditions. But the relatively new generation entrepreneurs with their mega projects threw up their hands. What can be done, if international commodity prices collapse, or if power tariffs do not cover the cost of production was the oft repeated justification; or if the coal block allotted by the government is taken away by judicial intervention. The facts of excessive leverage, low skin in the game of promoters and at times inflated project costs, were glossed over.

While it is unfair to paint everyone with same brush, many unscrupulous promoters seized the opportunity during the lending euphoria, sometimes with the help of bankers. Here is an egregious example. The borrower wished to “execute projects” in foreign countries. Towards this the borrower requested banks to issue performance guarantees. This appeared to be a legitimate request and banks obliged. Soon, the overseas banks of the beneficiaries invoked the guarantees, and the domestic banks were contractually obligated to pay. The money was never recovered. When the transaction was investigated, the whole scam unraveled. The promoter had registered trusts in offshore tax havens. The sole beneficiary of these trusts was the promoter. The trusts then incorporated legal entities/shell companies in other foreign countries. These shell companies controlled by the promoter pretended to have work contracts for which they sought performance guarantees from banks in the home country of the promoter. The guarantees were deliberately invoked and the local banks were forced to remit money in millions to overseas banks. Along with the money, the promoters are also known to have fled to tax havens leaving the tax payer at a loss. Such cases of corporate malfeasance are not isolated and have made a significant contribution to the current banking morass.

Enter Raghuram Rajan as the Governor of the RBI in 2013. Sensing that banks were ever greening loans (“extend and pretend that a loan is not a NPA”) by constantly restructuring and deferring loan payment installments, he ordered an Asset Quality Review(AQR) in 2015-16. The AQR resulted in banks making humongous provisions on hitherto unclassified NPA’s with a significant impact on the capital adequacy ratio of banks. The Common Equity Tier 1 ratio is a critical parameter of a bank’s health as per the Basel Committee for Banking Supervision. Here is a look at how some PSU banks’ CET1 ratio has been impacted by NPA’s.

	31.3.2015	**31.3.2016**	**31.3.17**
PNB	8.48	8.48	8.17
IDBI Bank	7.36	8.06	5.75
Bank of India	7.18	8.34	7.71
Bank of Maharashtra	7.48	7.18	7.28
Uco Bank	8.94	7.52	7.64

Source: disclosures by respective banks

IDBI bank has been relatively most impacted. Fall in CET1 ratio below threshold levels and inadequate reserves will affect the Additional Tier1 bonds issued by the banks under Basel norms. These bonds are quasi equity instruments with no repayment date, with bond holders carrying default risk much higher than plain vanilla bank deposits.

The various stressed loan resolution schemes like 5/25, SDR, S4A have not had the desired impact. Lack of decision making at banks to take haircuts on their bad loans has been hampering the efforts to clean up their balance sheets. Such a decision to write off could always attract investigations down the line and put off the risk averse bankers. The crux of the issue is the valuation of such non-performing loans with no mechanism in place to determine that in a transparent manner.

The US has an active market for distressed loans. Like equity quotes, the loan market provides quotes for syndicated corporate loans which are traded in the secondary market. The industry body Loan Syndication and Trading Association based in New York acts as a self-governing organization that seeks to increase transparency and efficiency in the loan markets. Such loan market associations exist in Europe and Asia Pacific too. Perhaps either the regulators or the market players in India should work towards building a transparent loan market though that will not be a solution for the immediate NPA clean up problem on hand.

The RBI in its Financial Stability report in June 2017, has estimated that Gross NPA's of banks may rise from 9.6 pct. in March 2017 to 10.2 pct. in March 2018. A buyer could emerge for any asset even if it is non performing in nature, provided the price is right. Asset Reconstruction companies which acquire NPA's have already been established in India though their capacity is a drop in the ocean compared to the humongous size of NPA's in the banking sector. Foreign funds can be sizable players provided banks are willing to take a decision to price the bad loans at a point that will make it attractive to buyers.

In order to force the hands of the dithering bankers, the Government passed the Insolvency and Bankruptcy Code (IBC) and subsequently through an ordinance empowered RBI to direct banks to refer defaulted loans for resolution through the bankruptcy code. If the borrowers and their lenders along with the Insolvency Professional are unable to come up with a viable plan for turning around a company within 180 plus a grace period of 90 days, then the borrower will be forced into liquidation. The new mechanism does not seek to address the issue of a lack of a transparent and efficient price discovery mechanism which is at the root cause of the lack of progress in NPA resolution and cleanup of banks' balance sheets. It remains to be seen if the IBC will nudge the stakeholders, viz. the lenders, borrowers, insolvency professionals, Asset Reconstruction Companies and other investors- to evolve such a mechanism over the next 6 months. Indian banking can then put aside its past NPA problems and start anew.

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