

# A study on NPAs of Public Sector Banks in India and its management

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**Abstract :** Non-performing Assets (NPAs) are referred to 'assets' (for banks, these are loan advances) which do not yield any form of income to their owners and simply lie idle (Gupta and Kesari, 2016). The Indian banking sector has been plagued with NPAs on a consistent basis, particularly the Public Sector Banks (PSBs). Rising NPAs is a cause for concern for any economy as banks are compelled to allocate significant proportions of their total capital in cleaning their balance sheets which, in turn, reduces their profitability and thereby, lowers their incentive to extend fresh loans to business enterprises in both the private and public sector.

In this paper, we will intricately analyze two of the most prominent stressed asset situations faced by the Indian banking sector – the first in the late 1990s and the second (which is presently ongoing) which surfaced following the Global Financial Crisis in 2008. We will go through the macroeconomic and banking conditions prevailing before each of the NPA crisis; compare the extent to which the public and private sector banks were hampered, especially in the current NPA episode; and examine the various measures adopted by the Government and the RBI to tackle the ongoing NPA situation. We shall also make recommendations that both banks and regulatory bodies, such as the RBI, can inculcate in order to deal with a stressed asset situation more methodically so that the functioning of the economy is not hindered.

**IndexTerms -** Non-performing assets (NPAs), Reserve Bank of India (RBI), Basle norms, Narasimham Committee, Bank recapitalization, Moral hazard.

## I. INTRODUCTION

The banking sector plays a pivotal role in any country's economy in the form of facilitating credit finance, particularly to capital-intensive sectors such as infrastructure, iron and steel, and automobiles, as well as fast-growing sectors including healthcare and pharmaceuticals. Owing to this relationship, the growth of the economy as a whole is significantly influenced by the overall performance of the banking and financial services sector.

In India, banking primarily comprises of commercial banks and co-operative banks. The former are further categorized into scheduled and non-scheduled commercial banks. Scheduled Commercial Banks (SCBs) are part of the Second Schedule of the Reserve Bank of India Act 1934, and are qualified as such based on specific criteria pertaining to their paid-up capital, cash reserves, etc. SCBs consist of public sector banks (such as the State Bank of India and its various branches), domestic private sector banks, foreign private sector banks, and regional rural banks.

In 1969 and 1980, nationalization of banks occurred on a large scale – 14 privately-owned banks in 1969 and 6 in 1980. Following the second round of nationalization, around 90% of the banking industry, measured by the proportion of total loan advances, comprised of public sector banks while the rest was made up of a few international banks and small privately owned banks. From 1980 to 1992, public sector banks in India were entirely owned by the government; State Bank of India was the first publicly listed bank in 1992.

Following liberalization in 1991, a number of committees were assigned by the Government to examine the functioning of the Indian banking sector and advocate policy measures to enhance the health, efficiency and competitiveness of the sector. In particular, two key expert committees headed by Mr.M. Narasimham (widely referred to as Narasimham Committee I and II) put forward a comprehensive framework for revamping the banking sector post liberalization.

The Committees vouched for measures such as the implementation of risk-based capital standards, standardized accounting procedures for income recognition, and facilitating for bad and unscrupulous debts. The purpose of these recommendations was to offer banks a yardstick for measuring against the best international banking practices exemplified in the Basel I norms put forward by the Basel Committee on Banking Supervision (BCBS). For instance, the Narasimham Committee I postulated that all banks would have to attain a capital to risk-weighted assets ratio or CRAR of 8% by 1996, which is a measure of a bank's paid-up capital to its total advances (and other assets) ratio.

The second committee made a number of recommendations on the lines of asset classification, raising banks' CRAR to 10% by 2002, and the formation of Asset Reconstruction Companies (ARCs) that would seize the stressed assets from banks. Moreover, the first Committee had recommended the issuing of new licenses to induce the setting up of more privately owned banks. Hence, the RBI allotted 11 licenses for the formation of private sector bank, although their share in the banking sector was minimal until 2000.

Further reforms proposed by the committees following liberalization included the deregulation of interest rates; permitting public sector banks to raise up to 49% of their total equity from the share markets; and a measured decrease of the Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR) to enhance the profitability of banks. As a result, the banking sector has flourished since the nationalization move – between 1969 and 2015, the number of commercial banks expanded from 89 to 152. Till 1991, the quality of assets was not a key priority of the RBI to monitor. Rather, their primary focus was on attaining performance objectives including expanding the number of bank branches, lending to the priority sector, setting up branches in rural areas, among others. But, in recent years, the quantum of loans extended by banks has been falling in proportion owing to an increase in the level of Non-Performing Assets being held by banks in India.

**Non-performing Assets (NPAs)** are referred to ‘assets’ (for banks, these are loan advances) which do not yield any form of income to their owners and simply lie idle. The Reserve Bank of India (RBI) has classified the assets held by Scheduled Commercial Banks (SCBs) into four distinct categories, out of which three are referred to as NPAs:

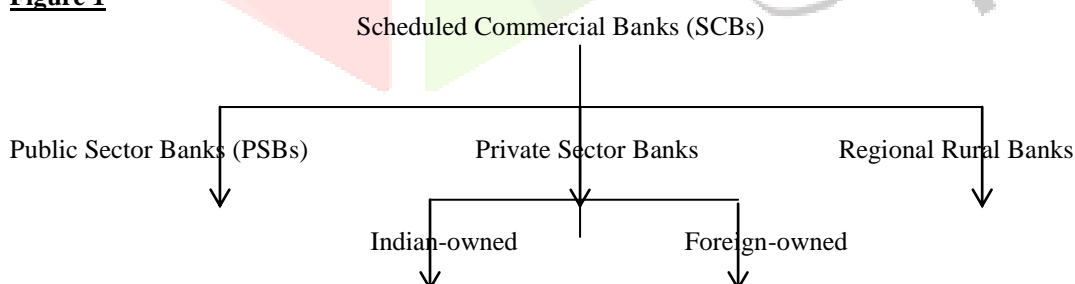
- a) **Sub-standard assets:** As per the classifications of the RBI released on 31 March 2001, a Sub-Standard asset was defined as one which continued to remain as an NPA for a period of at most 18 months. But, following the revised guidelines of the RBI published on 31 March 2005, a Sub-Standard is referred to as an asset which has remained as an NPA for a period not more than 12 months.
- b) **Doubtful assets:** Initially, under the RBI guidelines of 31 March 2001, as a doubtful asset would be an asset which has been an NPA for more than 18 months. However, from 31 March 2005, under the revised guidelines from the RBI, a doubtful asset is any asset which has been sub-standard one for at least 12 months.
- c) **Loss Assets:** A loss asset is a kind of NPA on which the bank holding the asset or an internal or external auditor has accepted a loss but the amount is not entirely irrecoverable. This implies that it does not make sense to continue to hold on to such assets even if some value could be recouped from its sale.

Between 2002 and 2008, the Indian economy grew at an average of 9% which was largely attributable to an expansion in the growth of credit to the tune of 22%. However, following the global economic crisis in 2008, India’s economic growth rate plummeted and subsequently, the demand for credit declined coupled with banks getting increasingly cautious to extend loans, particularly to Micro, Small and Medium Scale Enterprises (MSMEs). The quantum of NPAs in India nearly doubled from 5.7% of total net advances in 2008 to 10.2% in 2013, thereby hampering the rate of economic growth considerably.

## II. OVERVIEW OF THE BANKING SECTOR IN INDIA

The banking system in India primarily consists of commercial banks and co-operative banks, and commercial banks in turn are further classified into scheduled and non-scheduled commercial banks. Scheduled commercial banks (SCBs) belong in the Second Schedule of the Reserve Bank of India Act, 1934 and fulfill a number of conditions related to paid-up capital and reserves. SCBs comprise of public sector banks (State Bank of India its counterparts, nationalized banks, among others), Indian-owned private sector banks, multinational private sector banks, and regional rural banks (RRBs).

**Figure 1**



Banks in India underwent nationalization in two distinct stages – in 1969 and in 1980 (14 private banks in 1969 and 6 in 1980). Following the second stage of nationalization, around 90% of the banking sector in India was made up of public sector banks (measured in terms of percentage of total loan advances), while the remaining portion was split among multinational banks and very few private sector banks. Between 1980 and 1992, PSBs in India were wholly owned by the Government, and the first bank to be listed on the National Stock Exchange (NSE) was the State Bank of India in 1992.

Following the massive liberalization drive in 1991, the Government set up a number of committees to assess the operation of the Indian banking sector and propose modifications to reduce the staggeringly high level of Non-Performing Assets (NPAs) plaguing Indian banks and make them more financially viable and efficient. The two most prominent committees were headed by Mr. M. Narasimham and were set up in 1991 and 1998, respectively. The recommendations laid out by these committees, commonly referred to as the Narasimham Committee I and II, provided a clear direction for banking sector reforms to take shape in post-liberalisation India. A wide array of recommendations were put forward by the Committees, key among them being risk-based capital standards and consistent accounting practices for distinguishing between various forms of income, and anticipation of dubious loans. The intention of the Committees was to level the banks with the best international practices laid out in the Basle I norms drafted by the Basle Committee on Banking Supervision (BCBS).

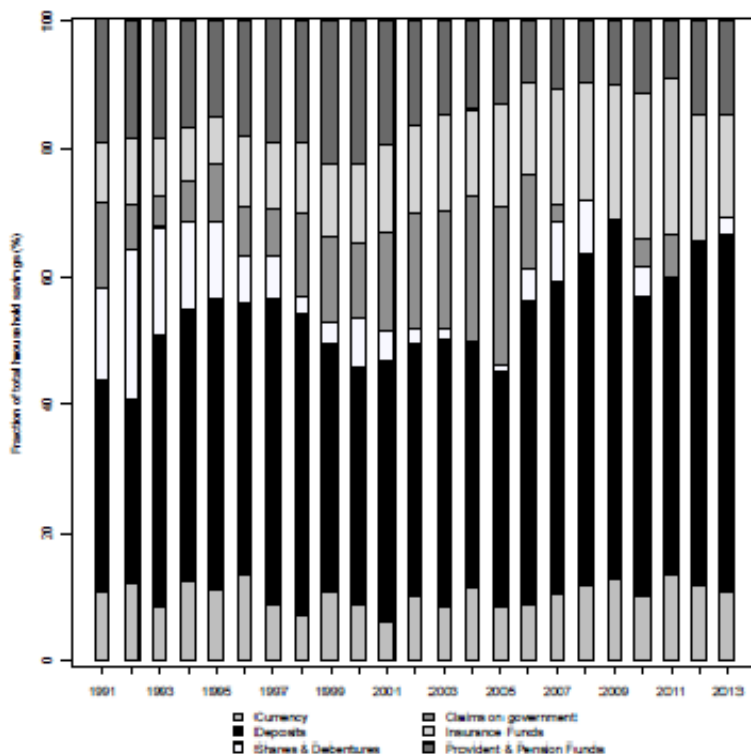
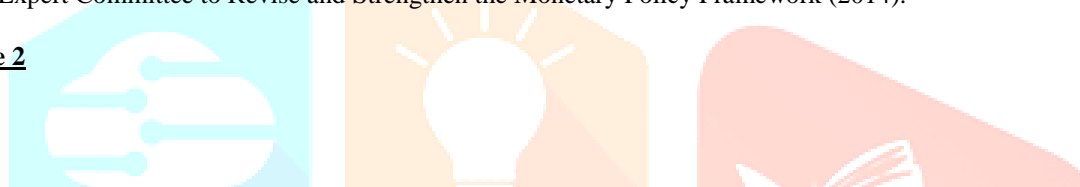
Moreover, among other key recommendations of the Narasimham Committee I, domestic banks had to adhere to a capital to risk-weighted assets system wherein they had to attain at least 8% capital to risk-adjusted assets ratio (CRAR) by 1996. CRAR is a measure of the ratio of a bank’s paid-up capital to its total loan advances and other assets. The Second Committee made several suggestions primarily regarding the categorization of assets, raising the banks’ CRAR to 10% by 2002, and establishing Asset Reconstruction Companies (ARCs) to which the dubious assets of banks would be transferred (Gopinath, 2007). RBI has since enforced, in a step by step manner, rules for categorizing asset, income identification, among other crucial norms.

The Narasimham Committee I also recommended issuance of new licenses to private sector entities to set up banks. Consequently RBI issued 11 licenses for setting up new privately owned banks. While most of these new private sector banks started functioning in the mid 1990s, their share in the banking business remained modest until 2000. Other banking sector reforms based on the committees’ recommendations included interest rate deregulation, allowing PSU banks to raise up to 49% of their equity in the capital market and gradual reduction of the Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR) to improve banks profitability.

Additionally, the Narasimham Committee I advocated handing out new licenses to encourage the setting up new private sector banks. Subsequently, 11 licenses were issued by the RBI for the establishment of new private sector banks. Though majority of privately owned banks began operating in the mid 1990s, their share in the total loan advances was minimal until 2000. Further reforms included deregulation of interest rates, permitting PSBs to procure up to 49% of their share capital from the equity market, and also lower the Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR) in a phased manner in order to raise the profitability of banks.

Ever since the nationalization of banks in India, the banking industry has flourished – between 1969 and 2015, the number of commercial banks shot up from 89 to 152. The reliance on procuring loans from banks has also risen astonishingly in recent years. Figure 2 in the following page explicitly highlights the allocation of households’ financial savings among various financial vehicles. The portion of savings parked in bank deposits has nearly doubled from around 35% in 1991 to about 60% in 2013. Further, the quantum of domestic credit as a proportion of the total GDP directed to private sector entities has swelled from 24% in 1992 to 53% in 2015. Banks hold a significant stake as a source of corporate credit – almost 60% as exemplified in the Report of the Expert Committee to Revise and Strengthen the Monetary Policy Framework (2014).

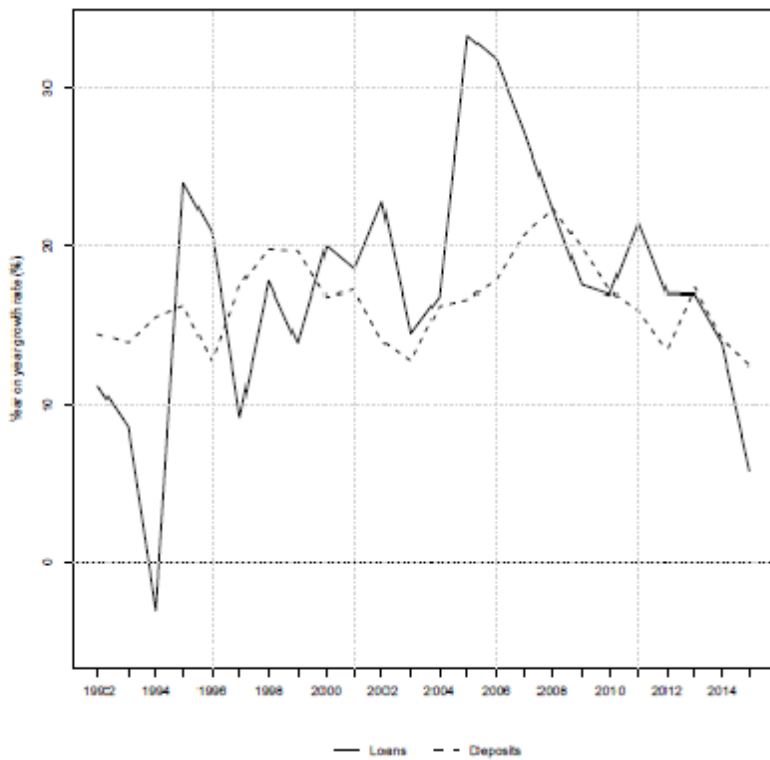
**Figure 2**



((Source - Reserve Bank of India. Various years. Statistical tables relating to banks in India))

The aforementioned statistics demonstrate that despite the Government’s concrete efforts to shift the financial system to a market-led one following the reforms of 1991, banks have continued to lead the way forward for the Indian economy. Figures 3 and 4 illustrate how the credit and deposits along with the assets of the banking sector have expanded over a period of time (from 1991 to 2015). Figure 5 exemplifies the proportions of bank deposits and bank loan advances in the total GDP, respectively, since 1991. But, since 2013, the rate of growth of loan advances in addition to the growth rate of bank deposits has been deteriorating. This is directly attributable to alarmingly high rate of growth of NPAs in recent years.

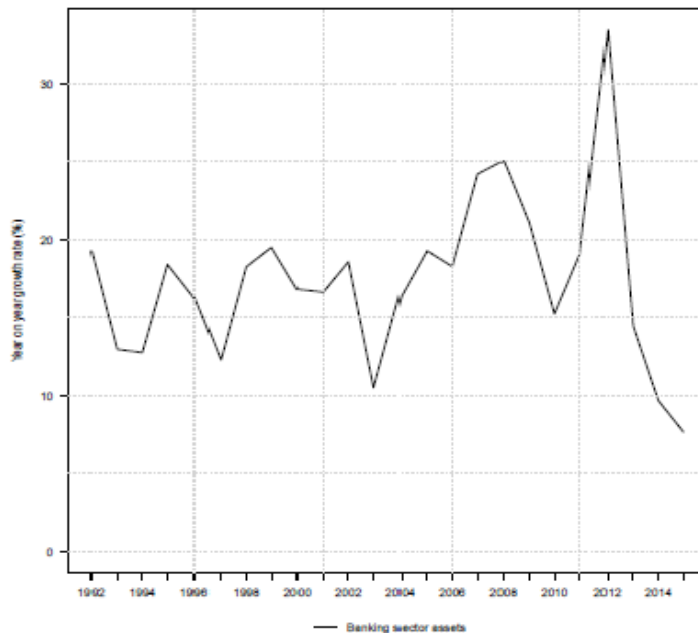
**Figure 3**



(Source - Reserve Bank of India. Various years. Statistical tables relating to banks in India.)

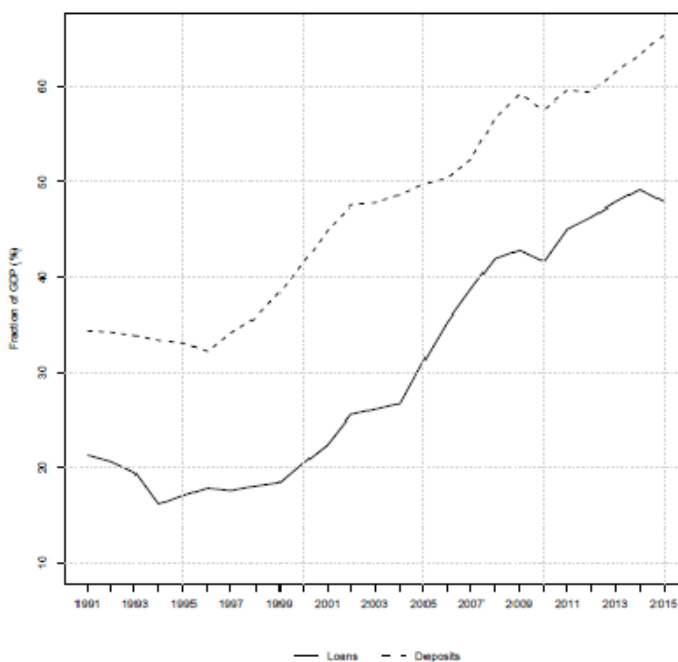
**Figure 4**

(Source - Reserve Bank of India. Various years. Statistical tables relating to banks in India.)



**Figure 5**

Source - Reserve Bank of India. Various years. Statistical tables relating to banks in India.



While the share of private sector banks has gone up over time the actual number of private sector banks has decreased since 2000. This is attributable to the fact that since the early 2000s, the RBI doled out very few licenses to individuals in the private sector to set up banking institutions, the growth of the economy notwithstanding. The fact that PSBs have a majority stake in terms of total loan advances is a distinctive characteristic, as only China is the other large economy in the world to share this feature. Even after 25 years of liberalization, PSBs have more than 70% stake in the banking sector, while the Government's stake in these banks exceeds 51%.

However, this fact is a cause for concern for two key reasons. First, bank recapitalization becomes a cause for alarm – a banking crisis always tends to reduce into a fiscal crisis since the Government is forced to assume a substantial share of the burden to recapitalize the PSBs, notwithstanding the fact that these banks are listed institutions now. Secondly, the supremacy of PSBs in India's banking sector creates a moral hazard problem as the RBI controls and administers all banks, and since PSBs hold a lion's share in the sector, a precarious situation is established. This is largely a result of the fact that both the Governor and Deputy Governors of the RBI are appointed by the Government. As aforementioned, the RBI regulates banking activities in India which is primarily dominated by the public sector.

Furthermore, PSBs in India were established by the Bank Nationalization Act of 1969, and unlike their private sector counterparts, PSBs are not administered by the Companies Act of 1956. This implies that a host of requisites surrounding disclosures, board governance, etc., included in the Companies Act do not pertain to PSBs. It can be inferred that PSBs face less inspection into their activities than their private sector counterparts; also, due to their pattern of ownership, there is the added risk of being swayed by the government and various political parties.

Such a high level of government participation may create a sense of invincibility among the depositors PSBs as they are supposedly assured of State guarantee. This was explicitly observed following the Global Financial Crisis in 2008, wherein the performance of PSBs in India outclassed that of private sector banks in spite of purportedly being more susceptible to the crisis (Acharya and Kulkarni, 2011). The supposed consistency of PSBs is largely attributable to assurances offered by the Government, which is also a prime factor for why a run on PSBs is seldom observed.

Besides, the Bank Nationalisation Act of 1969 regulating PSBs clearly states that in the event that a bank falls under financial troubles, the Government will step in to meet its commitments. Thus, with this backdrop, PSBs in India can never be in "crisis". A calamity can strike a PSB only if it has issues regarding its creditworthiness and credit adequacy, not liquidity trouble due to significant backing by the Government.

### III. MACROECONOMIC AND BANKING CONDITIONS PREVAILING BEFORE EACH CRISES

In this section, we will analyze and compare the two high profile NPA episodes in India – the first one which took shape following the banking crisis of 1997 and secondly, the present crisis which was initiated during the Great Recession in 2008. To begin with, the seeds of the banking crisis of 1997 were sown by the reforms of 1991 which involved liberalization, privatization, and deregulation. The year 1991 was a game changing one for the Indian economy as it was the year when the economy was first opened up to international trade. The banking industry which up until that year operated in an extremely protected environment for decades, required a wide-scale shakeup in order to match up to international banking norms.

As detailed in the prior chapter, reforms in the banking industry following the opening up of the Indian economy entailed liberalization of entry, establishment of bank supervision, and enforcement of norms based on globally accepted practices. Subsequently, a host of private sector banks began functioning from around 1995 - between 1990 and 1995, the number of private sector banks in India shot up from 25 to 32. By 1997, private banks held a market share of around 6%. During the mid-1990s there was a credit boom in the newly liberalized, privatized and deregulated economy. During 1992-96, bank credit to GDP ratio averaged at 18% and bank credit grew at close to 12% (Table 1).

**Table 1 -**

Variables	Banking Crisis 1 (1997-2002)	Banking Crisis 2 (ongoing)
	Values at the start of the crisis	
Share of PSU banks	87%	74%
Share of private banks	6%	20%
Bank credit to GDP	18.2%	31.6%
Bank deposit to GDP	33%	50%
Bank credit growth	12.4%	24.7%

(Source - Reserve Bank of India. Various years. Statistical tables relating to banks in India)

The liberalization, deregulation and privatization reforms of the early 1990s also triggered a big investment boom in the economy. It also paved the way for foreign firms to enter. This created competition for the existing domestic firms. Also when the licensing restrictions were removed, domestic firms rushed to expand capacity. But several of them were not able to adapt to the

changing environment or withstand competition from other domestic firms and foreign entrants and became economically unviable. This resulted in stress in the advances portfolio of the commercial banks.

Additionally, the reforms set off an investment mania in the economy as hoards of foreign multinationals entered the Indian market, engaging in various activities. This induced competitive pressures in the economy for domestic enterprises. Also, following the elimination of curbs on attaining operation licenses, a glut of domestic entities scurried to enlarge their capacity. But, majority of these enterprises were unable to sustain themselves owing to competition from large domestic firms and the new multinationals. This led to an alarmingly large number of defaults on loans, particularly those doled out by PSBs.

Along with private and public sector banks, Development Finance Intermediaries (DFIs) also began to play a crucial role in the provision of finance in the 1990s, and prominent among them were IDBI, ICICI and IFCI. These were institutions engaged in arranging long term credit for use by the industrial sector. Though DFIs did not take deposits, they still held a considerable portion of the commercial credit advances in the economy; in fact, nearly all the new industrial projects were financed by the DFIs.

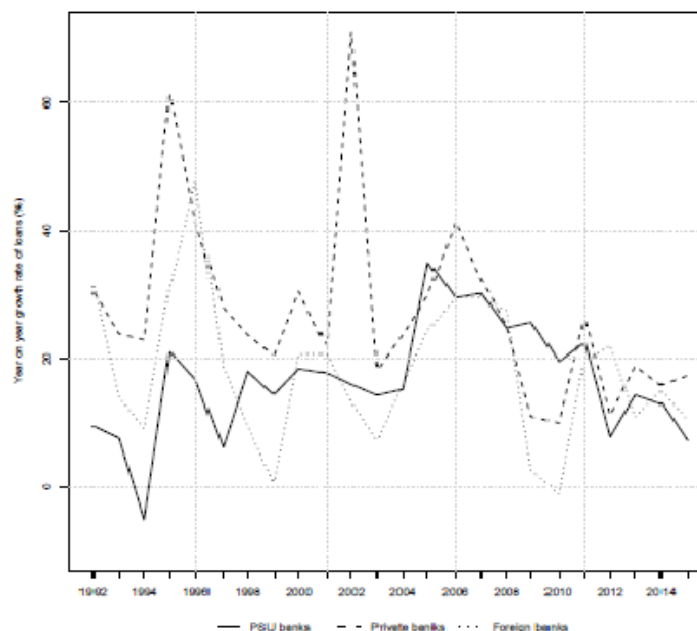
Prior to the macroeconomic and financial sector reforms in the 1990s, DFIs could procure capital from the RBI and multilateral agencies. They also relied on bonds issued by banks which fit their Statutory Liquidity Reserve (SLR) requirements. However, following the reforms in 1991, the operations of DFIs went through a drastic transformation as their access to cheap credit was cut off meaning that they would now have to go to the capital market to access credit. Further, they encountered cut-throat competition from banks which began funding projects at lower rates of interest.

This severely strained the financial position of the DFIs and their quantum of stressed assets skyrocketed to such excruciatingly high levels that by the late 1990s, they ceased to be financially feasible. In addition, in the late 1990s, the Indian economy succumbed to a host of external jolts – the Asian currency crisis in 1997; nuclear blasts performed by India in 1998; and to cap it off, the Internet bubble emanating from the USA burst in the year 2000. India faced severe repercussions as a result of the nuclear blasts in 1997 as international sanctions were forced upon the country.

These events culminated into a slow rate of economic growth – the average real GDP between 1997 and 2002 was a mere 5%, down from an average of 7.5% from 1994 to 1997. In a nutshell, the banking crisis of 1997-2002 stemmed from structural adjustments in the economy following the game-changing reforms in 1991 which was exacerbated by internal and external economic shocks, resulting in a full-blown downturn in the real economy.

The global and domestic economic environment along with the banking sector settings prior to the present banking crisis were in stark contrast with the crisis that struck between 1997 and 2002. The period between 2003 and 2008 was one of tremendous growth in real GDP, booming exports and advantageous macroeconomic circumstances in the form of low inflation and low interest rates. The banking industry also witnessed unprecedented growth as the volume of bank credit expanded at a remarkable rate of 25% between 2003 and 2007. Figure 6 below illustrates the rate of growth of credit by various bank groups over time.

**Figure 6 -**



(Source- Reserve Bank of India. Various years. Statistical tables relating to banks in India).

The credit market prospered to a greater extent in the mid 2000s than in the 1990s and thus, the quantum of NPAs was significantly larger in the former period than in the latter. Also, with DFIs wiped out of the industry due to their intractable level of stressed assets, the funding of industrial and large-scale projects became the responsibility of commercial banks. Without a liquid corporate bond market, lending credit for infrastructure projects was also the responsibility of commercial banks. PSBs in particular were engaged in financing infrastructure developments as they were increasingly liable to political pressures. The change in the structure of bank lending brought about a host of issues for 3 particular reasons.

First and foremost, private sector players were increasingly interested in participating infrastructure projects. Between 2003 and 2007, large private enterprises invested heavily in sectors such as aviation, telecom and mobile telephony, among other sectors that were previously dominated by the government. The demand for credit from these industries was unprecedented but commercial banks did not have the requisite expertise to evaluate the viability of these projects, particularly in the case of public sector banks.

Secondly, this situation also resulted in an asset-liability gap in the banks' balance sheets. Commercial banks did not enjoy a benefit which DFIs possessed – DFIs could dole out long-term credit for industrial projects as they had the backing of long-term bonds; commercial banks, on the other hand, rely on deposits as their primary source of finance, which have short maturity periods. Thus, commercial banks engaging in funding long-term projects through short term assets are bound to face a mismatch between their assets and liabilities owing to their different maturity periods.

Furthermore, lending to infrastructure caught banks off-guard as they were subjected to risks they were not acquainted to. These risks stemmed from innumerable delays and hindrances, such as the inability of the promoters to arrange the huge amount of credit required to kick start the projects. The government was also left in a precarious state as it was both the proprietor and source of capital to banks, and thus, was anxious about the alarmingly high level of risks that the PSBs assumed. Moreover, the Government was also a major player in the development of infrastructure, thereby the onus was on them to verify the credit worthiness of upcoming projects.

Broadly speaking, banks engaging in financing infrastructure projects bring about a plethora of challenges. Infrastructure financing contracts are vulnerable to political influences. Also, it is a challenge to foresee future demand while evaluating the viability of projects, while recovery and resolving of debt when a given project collapses is even tougher. For instance, reclaiming a cement factor is generally simpler than doing so for a bridge or a road.

By the onset of the present NPA calamity, the make-up of the banking industry in India transformed drastically. From the early 2000s, private sector banks gained traction and seized significant market share from PSBs. The share of PSBs in percentage terms as a proportion of the total credit advances dipped to around 70%. But since the size of the banking sector as a whole magnified, even though the stake of PSBs has fallen, the fiscal liability of the government has increased in absolute terms in the event that an NPA crisis hits.

The causes of the current banking crisis can be attributed to the wasteful lending by banks during the flourishing investment climate in India between 2003 and 2008. Further, in 2008, the Global Financial Crisis struck, which left the Indian economy in tatters as the rate of economic growth plummeted; the Indian rupee depreciated immensely; and high inflation forced the RBI to raise interest rates by cutting money supply. The aforementioned events left both the corporate and banking sector in turmoil. Directly following the 2008 crisis, governments across the world scurried to implement reforms in the financial sector and announced a great number of measures to tackle the recession. The Indian government undertook actions to curb the distressing slowdown in the economy. One surprising measure of the Government was to induce banks, the PSBs in particular, to dole out credit to the infrastructure sector, which had was in an extremely dire state following the slowdown in the economy, agonizingly long interruptions to procure clearances, and mounting costs.

The RBI being the supervising body revealed various restructuring schemes to permit banks to shelve rules related to identification on income and alter loans that are likely to turn into non-performing loans. This move was carried out keeping the over-leveraged enterprises in mind as they had access to even more funds now.

However, by 2011, the Indian economy experienced a full-blown recession and aggregate demand plummeted (Pandey et al, 2016), and this was unequivocally attributable to the downturn in the world economy, and subsequently, a plunge in demand for Indian exports. Furthermore, a number of corruption scams particularly in the coal and telecommunications industry also sparked the decline in the rate of economic growth rate. These scandals brought a lot of negative press on the Indian Government, thereby leaving the government trapped as they were unwilling to undertake any substantial structural reforms. Following the golden growth phase from 2003 to 2008, India's real GDP growth rate between 2011 and 2013 was a mere 6%. New projects were stalled owing to delays in government sanctions, and projects that were given the green light during the easy credit phase had to be suspended due to the downturn in the economy, particularly in the infrastructure sector. Consequently, the level of NPAs spiraled acutely in infrastructure, steel, metals, textiles, etc.

In the present banking crisis, wide spread attention was given to the NPAs issue in around 2013 but the problem began to take shape from 2010. The RBI announced a number of measures to aid banks in dealing with the quantum of stressed assets in their balance sheets which played an instrumental role to a certain extent. For instance, in April 2015, the RBI launched the Asset Quality Review (AQR) which compelled all banks (both public and private sector banks) to identify the exact value of NPAs on their books and subsequently, reserve funds in order to compensate for them. This directive by the RBI led to a considerable fall in the stock prices of many banks.

Within September 2015, 9 out of 10 of the banks with the highest level of NPAs were PSBs. This is a trend observed since 2006 (shown in Figure 8 in the following page) as the amounts of NPAs in PSBs have consistently exceeded the NPA levels in their private sector counterparts, barring years 2008 to 2011.



**Figure 7 –**

(Source - Reserve Bank of India. Various years. Statistical tables relating to banks in India.)



**Figure 8 – Gross NPAs to Gross Advances ratio**

(Source - Reserve Bank of India. Various years. Statistical tables relating to banks in India.)

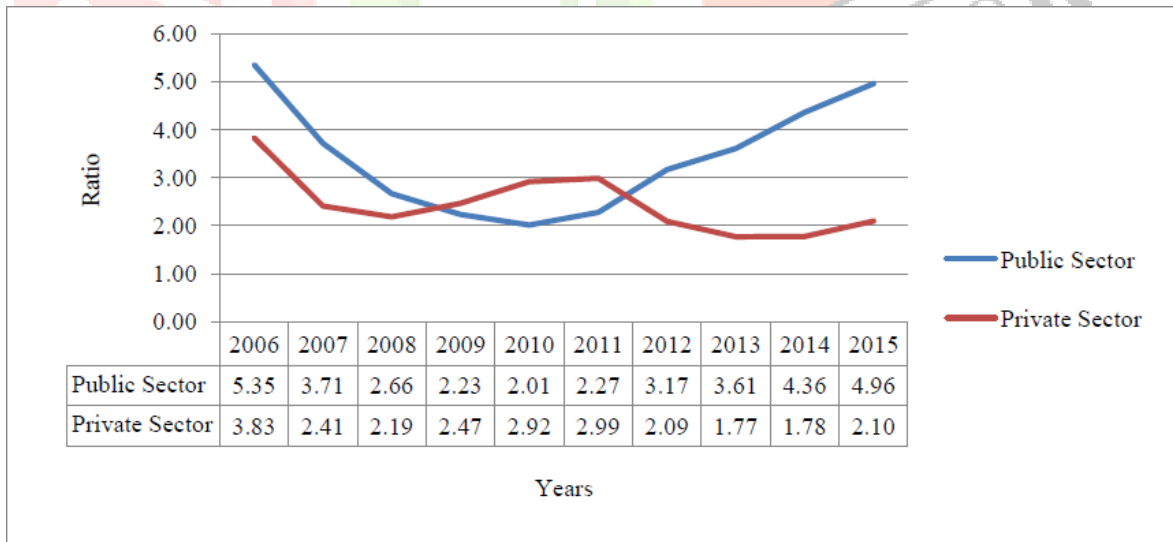


Table 2 below clearly illustrates that profits in the banking sector have taken a hit since 2012. In 2015, the ratio of NPAs to the total loan advances of all the banks cumulatively, in percentage terms was 7.5%. The unproductive use of bank capital to furnish their NPAs has hampered their ability to dole out new loans, and thus, the rate of growth of bank credit has been sinking over the last few years – from 13.8% in 2014 to 5.8% in 2015.

**Table 2 -**

Financial year	Return on Assets (%)	Return on Equity (%)
2008-09	1.1	15.4
2009-10	1.0	14.3
2010-11	1.1	14.9
2011-12	1.0	14.6
2012-13	1.0	13.8
2013-14	0.8	9.5
2014-15	0.8	9.3
2015-16	0.3	4.8

(Source: Reserve Bank of India. Various years. Statistical tables relating to banks in India.)

It is certainly going to be more challenging to resolve the ongoing NPA crisis considering the sheer scale of the challenge coupled with the global economic climate from which the crisis emanated. Moreover, developed economies like the US, UK, Eurozone members, and Japan have been steeped in an unrelenting recession stemming from the financial crisis of 2008, and therefore, the growth outlook for export-led industries looks dreary – a stark contrast from the situation in the mid-2000s. This is also a key reason for the declining rate of investment in the private sector since 2013.

In addition to the abovementioned challenges, in November 2016, the Indian economy faced a monetary jolt when the RBI under the direction of the Government revoked the legal tender status of high denomination currency notes (500 and 1000 rupee notes) which halted the distribution of about 86% of India's currency. This is likely to have exacerbated the distress faced by the banking sector as reflected by the substantial jump in the level of NPAs in 2016-2017.

#### **IV. POLICY MEASURES ENFORCED BY THE GOVERNMENT IN THE ONGOING NPA CRISIS**

The discussion in the previous section gives the impression that the solving the ongoing banking crisis will be an insurmountable exercise and a comprehensive attack will be required through reforms if normalcy is to be restored in the banking sector.

The Government has enforced a number of policy measures in an attempt to combat the NPA situation since the early signs of balance sheet struggles started to surface for banks from early 2011. The RBI announced a host of restructuring programs including Corporate Debt Restructuring, Strategic Debt Restructuring and Joint Lenders Forum; but, rather than resolving the pressing stressed asset problem faced by the banks, these measures enabled banks to conceal the actual amount of NPAs on their balance sheets – a phenomenon referred to as 'evergreening'. Consequently, the quantum of NPAs has escalated drastically since 2011-12 and thus, the availability of investible funds has been on a constant decline.

The alarming fall in the level of domestic investment activity in the Indian economy prompted the Government to implement the Indradhanush program in August 2015 to revitalize PSBs. It is a comprehensive seven-step blueprint involving the recapitalization or injection of funds into the banks. The Government reckons that the PSBs will require an estimated Rs. 180,000 crore till FY 2019 to wholly absolve of their NPAs – out of this, the Government intends to furnish PSBs with Rs. 70,000 crore over 4 years (2015-2019) through provisions from the annual Budget. 40% of this amount will be reserved for six of the largest PSBs; another 40% for banks that are on an extremely precarious state; and the remaining 20% will be allocated to banks following their performance (Kumar et al, 2016).

The proposed provisions for the recapitalization program began with Rs. 25,000 crore in 2015-2016 and 2016-2017, respectively, and were lowered to Rs. 10,000 crore in 2017-2018 and 2018-2019, respectively, resulting in a total budgetary provision of Rs. 70,000 crore. The remainder of Rs. 110,000 crore will have to be amassed by the PSBs themselves from the securities market so as to comply with the capital adequacy regulations laid out in the Basel III norms.

Widespread debates have taken place regarding the benefits and drawbacks of the proposed recapitalization drive of the Government which involves the use of taxpayer money. Various committees formed by the Government, including the Narasimham Committee I and the Nayak Committee – established by Mr. P. J. Nayak in 2014 – were thoroughly opposed to the infusion of capital into PSBs. This is attributed to the tremendous fiscal burden imposed on the Government as a result of such recapitalization schemes.

In addition, under the Indradhanush programme, the Government green lit a proposal to inaugurate a Bank Board Bureau (BBB) to assist in the selection of highly experienced executives in PSBs; but, improvements have been negligible following the arrival of the BBB in April 2016. In fact, the Indradhanush scheme – the only noteworthy measure adopted by the Government to address the present NPA situation – fails to deal with the stressed assets problem exhaustively.

Although the RBI did execute the AQR in order to coerce the banks into identifying the quantum of NPAs on their balance sheets and subsequently make reservations for them, it could be reasoned that had this step been implemented earlier, the losses plaguing banks currently could have been avoided entirely. The Government must adopt sweeping measures so as to ensure that the next NPA episode does not transform into a full-blown crisis, which would invariably save the taxpayers' money as well.

As a result, a few recommendations have been made in the following chapter.

## V. POLICY RECOMMENDATIONS

In order to deal with the problem of Non-Performing Assets (NPAs) effectively, the faster it is addressed, the better it will be for the economy as a whole. If the regulatory authorities continue to believe that the problem is self-correcting and delays the tackling of the problem, the quantum of NPAs is only going to widen. A three-pronged approach should be adopted in order to comprehensively deal with stressed assets in banks and this involves recognition, recapitalization and resolution.

Banks have largely identified the amount of stressed assets in their balance sheets as part of their Asset Quality Review (AQR), though this exercise must be prolonged until all the NPAs have been identified and provisions made for. Further, the primary objective of the RBI without a doubt has to be inducing banks to resume lending, and for this to be attained, capital needs to be injected into the banking system. The dearth of capital is more prevalent in PSBs as contrasting with private sector banks, the former are not in a position to raise capital in the open market without tempering the Government's share below 51%.

Hence, the Government is left with two options – either minimize its share in PSBs or deploy taxpayers' money to enable them to lend money again (a phenomenon already taking shape in the form of the Indradhanush program). However, the latter is not a prudent option as the country's fiscal deficit will come under tremendous strain, and as mention earlier, a moral hazard problem will be created whereby banks will have less inducement to refurbish their balance sheets on their own dime and instead, rely on the Government to come to their rescue.

Coming to the stage of resolution, a critical measure in the right direction has been taken with the enforcement of the Insolvency and Bankruptcy Code (IBC) in 2016, a law crafted to empower banks to absolve themselves from dubious assets within a short period of time; this is in sharp contrast with the earlier regime wherein banks would be confined with insurmountable piles of bad loans which would be nearly next to impossible to recover from bankrupt enterprises.

Immediately following the NPA crisis in the mid-90s, Asset Reconstruction Companies (ARCs) were instituted in order to handle the debt on the banks' balance sheets. But, their functioning over the years has been mired in regulatory troubles which have hindered their ability to guide banks out of their stressed asset distresses. Henceforth, the RBI should implement precautionary steps so that in the event bank advances exceed a given limit, remedies such as levying capital requirements and bounds on advancing loans to a particular sector of the economy can be enforced.

The aforementioned remedial measures carry the potential to drag the economy down but it is a worthwhile gamble for long-term steady growth. Also, as the Government holds around 70% control and ownership in PSBs, it needs to appraise whether having such a significant stake in the banking sector is viable, at least from the fiscal standpoint, since it is induced to shell out huge sums of money whenever these banks are in distress. It can be agreed that in a developing economy like India, the Government needs to oversee that funds reserved for development programs are being allocated correctly by PSBs, but, the Government could consider lowering its stake in these banks to a minority.

Furthermore, the merger of numerous PSBs is certainly going to improve their governance. For instance, it would take the Bank Board Bureau significantly less time to fill the Directors' seats for 10 PSBs as against carrying out the same exercise for suppose 20 PSBs. Recently, the Government has kickstarted the procedure for the merging of five affiliates of the State Bank of India (State Bank of Bikaner & Jaipur, State Bank of Travancore, State Bank of Patiala, State Bank of Hyderabad and the recently formed Bharatiya Mahila Bank) with the head bank. The intention behind this large scale merger was to enhance the operational competence of the SBI group as a whole. Although this is a positive sign, mergers of this kind need to be carried out consistently, particularly of smaller, weaker banks with the larger, healthier ones so as to enhance operational efficiency throughout the banking sector, and thus, upgrade their governance.

Finally, the banks will have to adopt more stringent processes when poring over loan applications, chiefly when the level of stressed assets on their balance sheets initially begin to mushroom and the economy is going through a boom which naturally will result in a credit bonanza.

## VI. CONCLUSION

A quick-fix solution to a banking calamity is simply to grow out of the crisis. But, this stance is viable only when three conditions are met:

- (a) The crisis is not very grave, that is, the degree to which stressed assets on the banks' balance sheets have appeared and the amount of funds required to furnish them is not inexorably high.
- (b) The source of the crisis stems from recurring macroeconomic factors.
- (c) The upturn in the economy following the crisis is drastic.

The abovementioned conditions were experienced by the Indian economy between 2003 and 2008 which put an end to the first NPA crisis in the late 90s. However, it is crucial to be aware of the fact that a sudden resurgence of the economy is not a common phenomenon, particularly after the banking sector of the economy has taken a hit – more often than not, the economic revival tends to be sluggish, as seen in the ongoing crisis.

Furthermore, the significance of time in the resolution process should not be underestimated. Early detection of stressed assets can curb the magnitude of a banking crisis, and for banks to be able to recognize these dubious loans, a hands-on approach by banks coupled with efficient running of operations is paramount. Such an active role in dealing with NPAs will safeguard banks from the draining of excess capital.

In addition, we need to be cognizant of the fact an economy swings from an upturn to a downturn in an uninterrupted manner, and banks being the primary lender of credit respond to the ebb and flow of the economy. During extremely favorable economic

conditions, the demand for credit is inherently going to be high and if banks dole out credit haphazardly, then it is highly likely that when the economy will experience a downturn, a large proportion of the loans will turn “bad”. Thus, NPAs are a characteristic of banking operations. But, if the quantum of NPAs is allowed to swell without getting recognized over a long period of time, normal banking activity will get hampered invariably and the economy may even enter into a deep recession which would be challenging to get out of.

Since the Indian banking sector is dominated by PSBs, any banking crisis tends to hamper the fiscal balance of the economy. Banks in India play a critical role as financial intermediaries (FIs) by directing the savings of small, individual account holders into the hands of investors (entrepreneurs). Hence, it is imperative that the Government and the RBI work in tandem to mend the banking sector, and also see to it that future stressed asset troubles do not transform into a crisis situation that could leave the economy in tatters. For this to be a reality, the Government will need to sincerely re-think the advantages of having a majority stake in the Indian banking sector; design a detailed blueprint for resolving crises stemming from NPAs; and enforce broad modifications in relation to the supervision and management of banks.

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