LOAN DEFAULTS

THE GREAT BANK ROBBERY

BAD LOANS

NPAs of public sector commercial banks in India: 2014-15

	In ₹ cr		As percentage of total assets	
	Gross NPAs	Net NPAs	Gross NPAs	Net NPAs
State Bank of India	73,508.5	37,277.7	2.8	1.4
Punjab National Bank	25,694.9	15,396.5	4.3	2.6
Bank of India	22,193.2	13,774.7	3.6	2.2
Bank of Baroda	16,261.4	8,069.5	2.3	1.1
Indian Overseas Bank	14,922.5	9,813.3	5.2	3.4
Canara Bank	13,040	8,740.1	2.4	1.6
Union Bank of India	13,030.9	6,919	3.4	1.8
IDBI Bank	12,685	5,992.5	3.6	1.7
Central Bank of India	11,873	6,807	3.8	2.2
UCO Bank	10,265.1	6,330.6	4.2	2.6
Allahabad Bank	8,358	5,978.9	3.7	2.6
Oriental Bank of Commerce	7,666.2	4,816.2	3.3	2.1
Corporation Bank	7,106.7	4,465	3.1	2
Andhra Bank	6,876.5	3,688.6	3.7	2
United Bank of India	6,552.9	4,081.4	5.3	3.3
Others	28,433.3	18,057.2	2.8	1.8
Total	278,468	160,208.2	3.2	1.8

The residual group 'Others' includes Syndicate Bank, Bank Of Maharashtra, Indian Bank, Dena Bank, Punjab and Sind Bank and Vijaya Bank. The percentages have been calculated from figures on total assets for each of the banks.

Source: Reserve Bank of India, Statistical Tables Relating to Banks in India 2014-15

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EXPERT VIEW
DEEPAK NAYYAR

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Bad loans of banks are in the news. Vijay Mallya, the flamboyant industrialist who owes public sector commercial banks more than ₹9,000 crore, took a plane to London last month just as the consortium of banks petitioned the Supreme Court to restrain him from leaving India. Following directions from the Supreme Court, the Reserve Bank of India (RBI) last week submitted a complete list of defaulters who owe public sector banks ₹500 crore or more, with a request that the names be kept confidential. Banner headlines speculate about amounts in loans written off by banks during the past year.

The same stories seldom refer to the fact that 12,360 farmers committed suicide in 2014. A very large proportion among them were driven to suicide by paltry debts owed to moneylenders, where the sums were in thousands. In sharp contrast, rich industrialists, who have not repaid bank loans that run into thousands of crore, continue to live in luxury, with ostentatious birthday bashes, mega weddings, luxury yachts, vintage cars, prime properties and what not. The asymmetry of this irony can be ignored only if morality is set aside.

The large dimensions of the problem emerge clearly from the table on the non-performing assets (NPAs) of public sector commercial banks. The definition of an NPA is simple. An asset becomes non-performing when it ceases to generate income for the bank. The figures on net NPAs are obtained by deducting, from gross NPAs, interest, part payments and insurance claims held in suspense account plus total provisions made by the bank towards writing off these loans should it become necessary. However, the difference between gross NPAs and net NPAs is essentially attributable to the provisioning for bad loans by banks in their accounts and balance sheets.

The table presents evidence on gross NPAs and net NPAs of all public sector banks in 2014-15 providing disaggregated statistics for 15 banks with the largest NPAs. It shows that their total gross NPAs were ₹2.785 trillion, while their total net NPAs were ₹1.6 trillion. The difference was attributable mostly to provisioning for (writing off) bad loans. The significance of these magnitudes becomes apparent only when compared with an appropriate denominator as a point of reference, although these liabilities of banks are not a part of either denominator. As a proportion of total assets of all public sector banks, gross NPAs were 3.2%, while net NPAs were 1.8%. As a proportion of the total domestic debt of the central government, the same gross NPAs were 5.8%, while the NPAs were 3.4%.

It is not as if the private sector is immune from this problem. In 2014-15, for all private sector commercial banks, total gross NPAs were 1.3% of total assets, while their total net NPAs were 0.8% of total assets. The probability of concealed NPAs in the private sector is higher. Even so, private sector banks did much better than public sector banks because they had a better balance in lending portfolios and a better assessment of credit risk.

The institutional setting also made a difference. Private sector and public sector banks are subject to the same regulation. Private banks fare better because they are subject to market discipline in the form of incentives and disincentives more than their public sector counterparts. Public sector banks fare worse because governance provided by government as the owner is much poorer than governance provided for their private sector counterparts by RBI as the regulator.

The problem is a serious cause for concern, particularly in public sector banks, for obvious reasons. It erodes their profitability insofar as provisioning for bad loans in balance sheets constitutes expenditure in annual accounts, thereby reducing profits pari passu. It dissuades them from lending to entrepreneurs or firms, so that bad borrowers drive out good borrowers. It imparts a financial fragility to the banking sector. Above all, ultimately, such outcomes impose a burden on people as depositors and citizens as taxpayers.

Three questions arise. Why are we in this mess? How do we address the problem? What must be done to pre-empt recurrence?

The historical origins can be traced to the nationalization of banks in 1969. It opened a window for bank lending on political behest. This began with populism, evolved through patronage, turned into quid pro quos, and culminated in rent-seeking. Such lending directed by successive governments, without exception, was imposed on public sector banks. Over time, it grew in scale and became larger than life.

Public sector banks themselves were also responsible. Their lending was sometimes inept and sometimes corrupt. Matters were made worse by institutional and systemic factors. For one, banks simply did not have the capabilities to assess credit risk in investment lending, because they had always been concerned with advancing working capital. For another, banks were caught in a maturity mismatch, because they borrowed short from depositors but had to lend long to investors.

These perennial underlying factors in politics and economics remained unchanged, but their interaction reinforced both, while the magnitude of the problem grew at the same pace as the growth of the economy, which gathered momentum after 1980. Hence, it is not new. But the problem has been exacerbated over the past decade by a sequence of developments.

The development finance institutions—IFCI, ICICI and IDBI—that had done much of the lending for investment in the manufacturing sector until then, began winding down in 2000 and were closed down in 2005. The mantle of investment lending fell partly on public sector banks. But they did not have the capabilities for assessing credit risk on long-term loans. However, the political factor driving lending was stronger as rapid economic growth rode the crest of the boom in the world economy. In these good times, no one anticipated bad times.

The global economic crisis that surfaced in late 2008 led to a massive downturn as growth plummeted everywhere and world trade contracted. India decided to inject a fiscal stimulus in early 2009 to combat the slowdown. To assist the process, there was a relaxation, or dilution, of the regulatory framework for provisioning by banks against bad loans. This softer regulation continued beyond what was necessary so that banks worried less about NPAs.

India was able to sustain its economic growth rates in the aftermath of this crisis. But growth slowed down starting 2011-12. This slowdown has persisted for five years. It has led to increasing economic stress on borrowers who invested in the boom, assuming that the good times would continue. The impact has been felt across sectors, but infrastructure, construction, steel, cement and mining are particularly stressed, leading to defaults that are not willful.

There has been a further deterioration during the last year as RBI has introduced tougher criteria for classification so that the NPAs of public sector banks that were concealed have now been revealed.

Alas, the legal process is a part of the problem rather than a solution. Banks have been reluctant to take loan defaulters to court because litigation is a prolonged process that extends for years and provides borrowers with an excuse not to make payments due as the matter is sub judice. The fundamental problem is that there is no sanctity to the law of contract in transactions between lenders and borrowers.

There are no simple solutions for a complex problem that has accumulated over time. Yet, corrective action is possible and necessary.

Information about NPAs of public sector banks must be placed in the pubic domain, contrary to RBI's recent plea in the Supreme Court, so that citizens and society can mount pressure on governments, banks and borrowers.

RBI needs to crack the whip and initiate tough action to discharge its duties as the regulator.

It is necessary to clean up balance sheets through provisioning for bad loans. Public sector banks have already made provision for almost 45% of their gross NPAs. This provisioning must continue with support from the government as the principal shareholder.

Such efforts would be wasted without ensuring that the problem does not recur in future. For this, some steps are essential.

Lending at political behest, for cronies or favourites, must end. Even if it is easier said than done, governance of public sector banks must be at arm's length from the government. Appointments of chairpersons or CEOs should be the domain of an autonomous body, in which the government can be represented. The recently constituted Bank Board Bureau is a step in this direction, but its independence from government influence cannot be assumed. Its autonomy will have to be established. Moreover, boards of directors should be independent enough to act as a buffer between management and government in commercial decisions. Careful supervision and regulation by RBI is imperative. This should include governance of public sector banks but that needs voluntary acceptance by the government.

It is essential that public sector commercial banks acquire the capabilities to assess credit risk in investment lending; they should also build in higher risk margins in setting interest rates depending on the past record of borrowers, even blacklisting those that have been large or habitual defaulters. The establishment of a National Development Bank with a mandate for, and expertise in, longer-term investment lending would also serve a valuable purpose.

Last but not least, there is an acute need for reform of the legal process that makes litigation time-bound, restores the sanctity of the contract between lenders and borrowers, and creates a bankruptcy law such that claims of banks for outstanding debt can be partly redeemed.

The time has come to address the problem here and now. If we do not, it could blow up. Such a crisis in the banking sector would have a devastating impact on output and employment in a market economy. The flaws in our political set-up and legal process are no alibi.

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