

AN EVERGREENING EXERCISE THAT HAS GONE UNNOTICED FOR TOO LONG

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

Regulators must turn their attention to the indirect evergreening of loans before these swell to levels that threaten stability

With the recent union budget proposing a bad bank to clean up bank NPAs, the issue of evergreening by banks has come to the fore. The evergreening of loans is a well-known exercise, in which banks revive a loan on the verge of default by granting further loans to the same firm. The consequences of evergreening are well known: a reduction in reported defaults in the short run, followed by an eventual explosion in default rates. The pattern has manifested in all major economies, including the US, the European Union, Japan and India. In most cases, the process of evergreening is direct: a troubled bank lends to a troubled borrower, and therefore, is detectable with some effort. In a recent paper, Nishant Kashyap, Srinivas Mahapatro and I highlight what we call 'indirect evergreening', in which banks and firms use related entities to evergreen loans. Worryingly, both markets and regulators seem to miss this phenomenon.

In the research paper, we examine the phenomenon of indirect evergreening using related entities in the Indian context. We examine 44,196 large corporate loans lent over a decade. The modus operandi can be explained through a stylized example. Consider a borrower B, who has a loan from a bank L. Assume that borrower B is in trouble and is not in a position to repay the loan. To hide this expected default, bank L could directly grant a loan to borrower B. However, such a transaction is easily detectable. The bank could be asked by the sector's regulator to justify repeated lending to a borrower in trouble. To avoid scrutiny, the bank lends the subsequent loan, intended to rescue the loan on the verge of default, to an entity, say B1, which is a related party of B. It could be a shell firm run by the promoters of B, or even an existing subsidiary. B1 then passes on the funds to B, who then uses the same to repay bank L. Thus, a loan from bank L gets used by a financially insolvent borrower to repay L's earlier loan.

Such indirect evergreening is more dangerous than direct lending to poor-quality firms, both because of its opaque nature and its consequences. First, we find that close to 5% of all large loans we studied were indirectly evergreened. Therefore, the phenomenon is economically meaningful.

Second, we find that both financial markets and regulators do a poor job of unearthing and preventing indirect evergreening. While bank stock prices react negatively to the renewal and/or restructuring of low-quality debt by banks that have large bad loans on their books, indirect evergreening seems to escape the market's radar. Thus, borrowers and lenders engaged in the exercise need not fear an immediate decline in stock prices, and hence, are likely to prefer this route over direct lending to troubled borrowers or formal debt restructuring.

Third, the phenomenon in question seems to have escaped regulatory scrutiny even though a detailed asset quality review (AQR) was conducted by the bank regulator. Banks were required to report divergences between the provisions made for loan losses by them and what the Reserve Bank of India (RBI) considered appropriate after the AQR. We find that these divergences are positively correlated with direct evergreening done by way of loan restructuring. However, our measure of indirect evergreening is not significantly associated with the reported gaps. In other words, banks that engaged in indirect evergreening were not asked to make

additional provisions after the AQR.

We further find that the practice of indirect evergreening accelerated after the AQR, as direct evergreening through restructuring or lending became difficult on account of increased RBI supervision.

The practice of indirect evergreening cannot go on forever. Ultimately, either when depositors realize what is going on, or when the economy faces a shock such that banks cannot keep lending for want of capital, the chain of indirect evergreening will break down and borrowers will start defaulting. We find that evergreened loans eventually end up in default.

It is not surprising, therefore, that banks like Yes Bank, which was relatively less hurt by the AQR, saw an explosion of default rates and reached a point of technical failure. The buildup of toxic assets by indirect evergreening could be one possible explanation for this. In fact, going by our measure, Yes Bank ranked No. 1 among banks in terms of the proportion of indirectly evergreened loans just before its collapse.

The implications of indirect evergreening go beyond banking to the industrial economy. Industries that are dominated by firms that are beneficiaries of indirect evergreening see a significant distortion in credit, with 'zombie' firms cornering most of the credit and leaving startups and other productive firms high and dry for want of credit. The process of Schumpeterian creative destruction gets halted, with firms that should have ceased to exist lingering on longer and firms that should have taken their place not being able to obtain resources. Thus, overall productivity and employment end up being far lower than their likely levels in the absence of evergreening.

Our data sets show a rising trend in the country of indirect evergreening with time. The practice seems to be prevalent among many cooperative banks and non-banks as well. Indian regulators must take up this issue and act before it is too late. They will have to enhance their audit toolkit to be able to detect indirect evergreening. Even a bad bank solution will not work if bad assets are not identified properly in the first place.

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