Why Indian bankers are on overdrive to clean up books

The December Financial Stability Report of the Reserve Bank of India (RBI) suggests that the gross non-performing assets (NPAs) in the Indian banking system may rise from 10.2% in September 2017 to 10.8% in March 2018, and an even higher 11.1% by September 2018. I have spoken to quite a few bank chiefs, including Rajnish Kumar, chairman of State Bank of India—the nation's largest lender—on their outlook on bad assets and most of them feel the worst is behind us. Still, NPAs may inch up. This may not be driven by the creation of fresh bad assets, but the collective aggression of bankers to clean up their balance sheets by moving some of the stressed assets into the basket of NPAs.

Indian banks are no longer in denial mode. Until about a year back, they were slow in recognizing bad assets—such recognition hits their balance sheets since they need to provide for or set aside money for NPAs. Which is why, traditionally, bankers try hard to not to allow any loan to slip into NPAs through various ways, including giving fresh loans to the group company of a likely defaulter, popularly known as "evergreening". But the relentless pressure of the banking regulator has changed the scene. The bankers are not taking any chances for any loan account any more. Once it's gone bad, they are swift in classifying it as an NPA and providing for it. Indeed, it hits their profitability but so be it.

The central bank had launched the so-called asset quality review or AQR in the second half of 2015 under which its inspectors checked the books of all banks and identified bad assets. The bankers were directed to come clean and provide for all bad assets by March 2017. The Indian Banks' Association, a national body for the banking industry, lobbied hard for more time to make such provisions but the RBI did not extend the deadline. On top of that, the central bank started forcing banks to disclose the divergence between the RBI's assessment of the loan books and the banks' recognition of bad assets in the notes to accounts to their annual financial statements. The objective is to depict "a true and fair view of the financial position" of each bank. This has embarrassed quite a few banks.

The RBI hasn't stopped at that. An ordinance was promulgated last year, amending the Banking Regulation Act 1949, giving powers to the central bank to push the banks hard to deal with the bad assets. The banking regulator has also been authorized to direct the banks to invoke the Insolvency and Bankruptcy Code against the loan defaulters. Since then, it has forced the banks to move against at least 40 bad accounts in two phases. The banking regulator is even directing the banks on which rating agency to appoint, for evaluating the feasibility of each and every resolution process within a specified time frame. A consultancy firm is to be engaged for preparing the techno-viability report of a restructuring plan and two rating agencies must rate this. The minimum eligibility for a loan account to be restructured is a BBB-, the lowest investment grade rating. Often the time given to a rating agency for such an exercise is too short.

While one may question the extent of micro-management being done by the RBI, the series of actions—ranging from AQR to mandatory disclosure of the divergence between the RBI's assessment and banks' recognition of bad assets, and the amendment of the banking law empowering RBI to direct banks on moving the insolvency court against defaulters—makes it clear that the regulator does not trust the banks when it comes to dealing with bad assets.

This is at the root of the radical change in banks' approach to NPAs. Once shy in recognition and resolution of NPAs for fear of being hit on profitability and backlash from investors, bankers are now bold and walking the extra mile to settle with loan defaulters. They don't care much about the depth of the haircut and impact on their balance sheets.

This explains why lenders have decided to refer 25 in the list of 28 defaulting companies to the National Company Law Tribunal (NCLT) for insolvency proceedings. These 28 companies are on RBI’s second list of defaulters sent to banks in August. The banks were directed to finalize the resolution plans by 13 December, failing which reference to the NCLT by the year-end was a must. Going by media reports, the three loan accounts for which the banks were able to work out resolutions involve Jaiprakash Associates Ltd, BILT Graphic Paper Products Ltd and Soma Enterprises Ltd. The RBI had sent its first list of 12 large defaulters to banks in June. Between them, these 40 loan accounts have roughly 40% share of the Rs10 trillion bad assets in the Indian banking system.

Once an account is referred to the NCLT, the resolution process is fast-tracked, but the realization will definitely be less than what one would have expected had the case been resolved through discussions. Banks are bound to disclose the liquidation value of an asset while asking for bids for selling an asset after the discussion for resolution fails. Once the liquidation value is known, the prospective bidders typically top it up marginally while bidding for an asset. So, the valuation gets depressed.

Also, once an account is referred to the NCLT, a running company (which may not be earning enough to clear bank dues) gets affected in many ways. For instance, its raw material suppliers may narrow the window for credit. Similarly, the referred company may find it difficult to get its receivables from the companies to which it supplies products. Under pressure, the company may start cutting down its workforce. It’s another matter that the share prices of those companies referred to the NCLT have been rising.

Overall, the value of the asset erodes. After referring to the NCLT, the bankers will probably be able to realize 20-25% of their dues from some of the defaulters, if they are lucky enough. Still, they are going ahead with insolvency proceedings as they don’t want to get hounded by the investigative agencies—Central Bureau of Investigation, Chief Vigilance Commission and India’s chief auditor, the Comptroller and Auditor General—for taking a deep haircut and resolving some of the bad assets themselves and not moving the NCLT. Indeed, there are oversight committees, or OCs, responsible for bad loan resolutions but they are involved in only those cases where a loan account is being restructured under the so-called sustainable structuring of stressed assets (S4A) scheme.

The bankers, who are professional managers, have never had any skin in the game. But till now, they were conservative in both bad asset recognition and resolution as they did not want their balance sheets to look ugly. With an aggressive banking regulator breathing down their necks, they now have nothing to lose. They are upset, angry and on an overdrive in their clean-up operation.

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