

## The two facets of NPA management

The phenomenal increase in non-performing assets (NPAs) and wilful defaults over the last three years raises serious concerns about the effectiveness of NPA management. Given the potential adverse impact that the increasing incidence of NPAs might cause, it is critical that NPA resolution takes place in a timely manner. Policies concerning NPA resolution must address two critical aspects: first, how to prevent it occurring at this scale in the future? and second, how to manage the existing accumulated NPAs?

Till recently, most of the initiatives by the government and the RBI (Reserve Bank of India) had centred on the latter — how to manage the existing NPAs. The emphasis was on finding ways to reduce the magnitude of NPAs. This was driven by the idea that bank balance sheets must be cleaned up and restored. While it is important to clean up the balance sheet of banks by reducing or eliminating bad loans, preventive measures are equally important. Typically, preventive measures are structural in nature. Both elements are quite important to a robust NPA management mechanism.

### Regulator's role

The government and the regulator have to play a greater role in the process of NPA management. The role of the government has historically been crucial when there is a banking failure or crisis. It is the government which comes to the rescue, either through direct intervention or through the regulator. The role of government becomes even more important as it happens to be the principal owner of majority of the affected banks in India.

On preventive measures, there is a need for evolving a framework in order to bring transparency into the operation and management of SCBs (scheduled commercial banks), particularly the PSBs (public sector banks), on four major parameters — project appraisal, monitoring, accounting, and auditing. As large loans constitute a substantial portion of the total NPAs, a robust credit appraisal mechanism is crucial. As large loans tend to be relatively technically complex, banks must enhance their technical capabilities to undertake project monitoring effectively. Greater emphasis must be placed on bringing efficiency and transparency into the accounting system. Emphasis should be given on strengthening the audit system in banks. These measures can potentially reduce the possibilities of collusion among the officials of the funding institutions and the borrowers.

### 'Bad bank'

On NPA resolution, to deal with the existing accumulated NPAs, there is a need for creating a publicly funded 'bad bank' or an asset management company which will deal with the stressed assets of PSBs. The approach should be to formulate a resolution mechanism which will maximise recovery, and thereby, reduce the burden on the banks or the government. It can be very similar to the Swedish model where the bad bank bought the stressed assets from the affected banks and sold it at a higher price at the time of economic expansion, when asset prices picked up. This way, recovery on the bad loans can be maximised. The life span of the Swedish bad bank 'Securum' was 15 years, and it was fully owned by the government.

On a similar line, the Government of India, too, can create a bad bank, with full government ownership. The proposed institution can continue to exist without an expiry date as the NPA problem is perennial. The Swedish bad bank ensured the principle of transparency in its true spirit, with full disclosure of the extent of the problem and its resolution mechanism. This gave a boost to the restoration of confidence in the banks, which was central in such a crisis. The managerial staff

of the 'bad bank' may, however, be outsourced to boost operational efficiency.

The bank should function independently and be accountable to government.

Given the fiscal constraints, it may not be viable for the government to finance the proposed bad bank through budgetary support fully. The government can, however, partly finance the proposed 'bad bank' by issuing equity shares with the government holding the majority share.

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**Emphasis should be given on strengthening audit system in banks**

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