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# THE PRS BLOG » EXAMINING THE RISE OF NON-PERFORMING ASSETS IN INDIA

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

The issue of Non-Performing Assets (NPAs) in the Indian banking sector has become the subject of much discussion and scrutiny. The Standing Committee on Finance recently released a report on the banking sector in India, where it observed that banks' capacity to lend has been severely affected because of mounting NPAs. The Estimates Committee of Lok Sabha is also currently examining the performance of public sector banks with respect to their burgeoning problem of NPAs, and loan recovery mechanisms available.

Additionally, guidelines for banks released by the Reserve Bank of India (RBI) in February 2018 regarding timely resolution of stressed assets have come under scrutiny, with multiple cases being filed in courts against the same. In this context, we examine the recent rise of NPAs in the country, some of their underlying causes, and steps taken so far to address the issue.

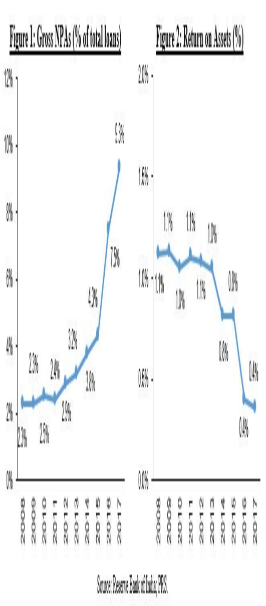
**What is the extent and effect of the NPA problem in India?**

Banks give loans and advances to borrowers. Based on the performance of the loan, it may be categorized as: (i) a standard asset (a loan where the borrower is making regular repayments), or (ii) a non-performing asset. NPAs are loans and advances where the borrower has stopped making interest or principal repayments for over 90 days.

As of March 31, 2018, provisional estimates suggest that the total volume of gross NPAs in the economy stands at Rs 10.35 lakh crore. About 85% of these NPAs are from loans and advances of public sector banks. For instance, NPAs in the State Bank of India are worth Rs 2.23 lakh crore.

In the last few years, gross NPAs of banks (as a percentage of total loans) have increased from 2.3% of total loans in 2008 to 9.3% in 2017 (Figure 1). This indicates that an increasing proportion of a bank's assets have ceased to generate income for the bank, lowering the bank's profitability and its ability to grant further credit.

Escalating NPAs require a bank to make higher provisions for losses in their books. The banks set aside more funds to pay for anticipated future losses; and this, along with several structural issues, leads to low profitability. Profitability of a bank is measured by its Return on Assets (RoA), which is the ratio of the bank's net profits to its net assets. Banks have witnessed a decline in their profitability in the last few years (Figure 2), making them vulnerable to adverse economic shocks and consequently putting consumer deposits at risk.




**What led to the rise in NPAs?**

Some of the factors leading to the increased occurrence of NPAs are external, such as decreases in global commodity prices leading to slower exports. Some are more intrinsic to the Indian banking sector.

A lot of the loans currently classified as NPAs originated in the mid-2000s, at a time when the economy was booming and business outlook was very positive. Large corporations were granted loans for projects based on extrapolation of their recent growth and performance. With loans being available more easily than before, corporations grew highly leveraged, implying that most financing was through external borrowings rather than internal promoter equity. But as economic growth stagnated following the global financial crisis of 2008, the repayment capability of these corporations decreased. This contributed to what is now known as India’s Twin Balance Sheet problem, where both the banking sector (that gives loans) and the corporate sector (that takes and has to repay these loans) have come under financial stress.

When the project for which the loan was taken started underperforming, borrowers lost their capability of paying back the bank. The banks at this time took to the practice of ‘evergreening’, where fresh loans were given to some promoters to enable them to pay off their interest. This effectively pushed the recognition of these loans as non-performing to a later date, but did not address the root causes of their unprofitability.

Further, recently there have also been frauds of high magnitude that have contributed to rising NPAs. Although the size of frauds relative to the total volume of NPAs is relatively small, these frauds have been increasing, and there have been no instances of high profile fraudsters being penalised.

**What is being done to address the problem of growing NPAs?**

The measures taken to resolve and prevent NPAs can broadly be classified into two kinds – first, regulatory means of resolving NPAs per various laws (like the Insolvency and Bankruptcy Code), and second, remedial measures for banks prescribed and regulated by the RBI for internal restructuring of stressed assets.

The Insolvency and Bankruptcy Code (IBC) was enacted in May 2016 to provide a time-bound 180-day recovery process for insolvent accounts (where the borrowers are unable to pay their dues). Under the IBC, the creditors of these insolvent accounts, presided over by an insolvency professional, decide whether to restructure the loan, or to sell the defaulter's assets to recover the outstanding amount. If a timely decision is not arrived at, the defaulter's assets are liquidated. Proceedings under the IBC are adjudicated by the Debt Recovery Tribunal for personal insolvencies, and the National Company Law Tribunal (NCLT) for corporate insolvencies. 701 cases have been registered and 176 cases have been resolved as of March 2018 under the IBC.

**What changed recently in the RBI's guidelines to banks?**

Over the years, the RBI has issued various guidelines aimed at the resolution of stressed assets of banks. These included introduction of certain schemes such as: (i) Strategic Debt Restructuring (which allowed banks to change the management of the defaulting company), and (ii) Joint Lenders' Forum (where lenders evolved a resolution plan and voted on its implementation). In line with the enactment of the IBC, the RBI, through a circular in February 2018, substituted all the specific pre-existing guidelines with a simplified, generic, time-bound framework for the resolution of stressed assets.

In the revised framework which replaced the earlier schemes, the RBI put in place a strict deadline of 180 days during which a resolution plan must be implemented, failing which stressed assets must be referred to the NCLT under IBC within 15 days. The framework also introduced a provision for monitoring of one-day defaults, where incipient stress is identified and flagged immediately when repayments are overdue by a day.

Borrowers whose loans were tagged as NPAs before the release of the circular recently crossed the 180-day deadline for internal resolution by banks. Some of these borrowers, including various power producers and sugar mills, had appealed against the RBI guidelines in various High Courts. A two-judge bench of the Allahabad High Court had recently ruled in favour of the RBI's powers to issue these guidelines, and refused to grant interim relief to power producers from being taken to the NCLT for bankruptcy. All lawsuits against the circular have currently been transferred to the Supreme Court, which has now issued an order to maintain status quo on the same. This means that these cases cannot be referred to the NCLT until the Supreme Court's decision on the circular, although the RBI's 180-day deadline has passed. This effectively provides interim relief to the errant borrowers who had moved to court till the next hearing of the apex court on this matter, which is scheduled for November 2018.

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