Stressed Asset Management for Banks in India

Suresh Chandra Bihari

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Foreword

Bimal Prasad Sharma

Executive Director
Bank of India

Since last decade or so, Banking Industry is under stress on account of its assets becoming non-performing thereby ceasing to generate income for the bank. The impact is universal and nobody, be it the bank, the individual customer or the economy itself, is untouched of the curse. This has taken the Financial Regulators and the Government itself to try to bring in innovative steps and drastic changes to curb the problem, however, despite all measures, now stressed assets are getting increased attention as the trend of deteriorating asset quality has emerged as a big economic risk not for the Indian banking sector only but for the global economy. Certainly, Stressed Assets is a powerful indicator of the health of the banking system and is requiring a robust mechanism to be dealt with.

The problem is requiring all stakeholders including customers to deal the issue in collaborate and rigorous manner. But the difficulty is that are the financial terms so easy to grasp? The answer is definitely no. In the midst of the universal concern, the book **"Stressed Asset Management in Banks"** by Dr. Suresh Chandra Bihari provides a valuable window on Stressed Assets Management and covers the necessary components.

The challenges in Stressed Assets Management are both difficult and interesting. People are working on them with enthusiasm, tenacity, and dedication to develop new methods of analysis and provide new solutions to keep up with the ever-changing threats. In this new age of global interconnectivity and interdependence, it is necessary to provide practitioners, both professionals and students, with state-of-the-art knowledge on the frontiers in the sector. This book is a good step in that direction.

With best wishes!

Sd/-
(Bimal Prasad Sharma)
Executive Director – Bank of India

Preface

In India, not only the banking industry is growing manifolds, also the competition is increasing exponentially. To sustain in such competitive environment, asset growth is one of the key factors of success. However, given the dynamism of the banking and financial industry at times some assets under-perform, such assets are termed as stressed assets.

Stressed assets adversely affect the business of the banks and hence, require timely and orderly recovery. The economic slowdown have only accentuated the need for management of stressed assets in an efficient manner expeditiously. This calls for a specific skillet in bankers.

Stressed assets management is the biggest concern today for all the banks—big or small, public or private. The controller of banking industry in India – RESERVE BANK OF INDIA is constantly monitoring the stressed assets of banking industry—issuing guidelines from time to time, giving directions and actively engaged in all possible ways to check the menace of stressed assets.

To discuss threadbare the various issues related to stressed asset, and mainly to focus the ways and means to prevent, contain and reduce the stressed asset portfolio of the banks is the objective of this book.

Dr. Suresh Chandra Bihari

Acknowledgements

"Behind every successful man, there is a woman" goes the popular saying. I am no exception to this and behind my successful pursuit of academic passion, leaving behind a three decade old financial profession, there is continuous support and inspiration of my wife Manu, whom I consider the incarnation of both Goddess Laxmi and Saraswati in my life. I give full credit for all my academic achievements, including this book to my wife and my only child, my dear son Sumit, both of whom support, inspire and rejuvenate me round the clock.

I dedicate this book to my late father who always saw in me an outstanding academician as well as my mother who showers her blessings to me for making continuous progress in life.

I also owe to all my family members as well as all my past and present colleagues and friends who constantly inspire me.

I am also thankful to Mr. Padma Lochan Jena, Computer Operator, who has greatly helped me in preparation of this manuscript.

Last but not the least, the book could not have seen the light of the day but for the untiring efforts of all the stakeholders of **Himalaya Publishing House Pvt Ltd.**

Dr. Suresh Chandra Bihari

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Introduction

1.1 INTRODUCTION

Today, the biggest concern for Banks is the Management of Asset Quality. With every passing day, more and more Banks from both the Public Sector as well Private Sector are reporting deterioration in Asset Quality. Loans and Advances constitute over 70% of the assets of most banks. Hence, it is absolutely essential for banks to manage tightly the credit risk, namely, the risk of default by the borrowers. As the largest intermediaries, banks are essentially managers of risk and the most important risk they have to manage is the credit risk. From a people dependent exercise it has been made a system dependent exercise. Despite the development of sophisticated appraisal techniques, credit decisions continue to be highly subjective because it is more judgmental rather than analytical except perhaps in the case of small value retail and small business credit.

1.2 BACKGROUND

Loans and advances are the most important part of balance sheet of banks. They typically comprise a majority of a bank's assets and carry the greatest amount of risk to their capital. Other items that contribute to the risk are securities, real estate and other assets, off-balance sheet items, and, to a lesser extent cash and due from accounts, and premises and fixed assets.

It is due to this riskiness; management often expends a significant amount of time, energy and resources administering their assets, particularly their loan portfolio. Problems within this portfolio may hit the profitability of banks, the deterioration in capital and important financial ratios. These may lead to reduction in the value of its stocks and the market value.

1.2.1 Important Ratios for Determining Assets Quality of Banks

The following ratios indicate the asset quality in banks:

1. Loan loss provisions/Gross Advances
2. Loan gross Provisions/Pre-Provision Income
3. NIM adjusted for credit provisions/Gross NPAs

4. NPAs/Total Advances
5. Net Interest Earned/Loan Gross Provisions
6. Allowance for Restructured assets/Gross Advances

1.3 SIGNIFICANCE OF ASSET QUALITY IN BANKS

In a bank dominated economy such as India, the asset quality of the banking system has important implications for the stability of the overall financial system. The general perception about a bank's health is greatly determined by the level of Non-performing Advances (NPAs) held in its books. It is, therefore, not surprising that the current spurt in NPAs in banks has attracted a lot of attention.

The business of banking essentially involves intermediation – acceptance of deposits and channelling those deposits into lending activities and credit risk is a direct fallout of this intermediation process. Certain amount of default and impairment of assets are likely to show up in the normal course of banking business and hence, credit risk management assumes a critical role in ensuring that such impairment is contained to a minimum.

Needless to say, when banking was simple, credit risk management was also straightforward. Lending decisions were made on impressionistic basis as the banks knew their borrowers and their businesses quite closely and hence they did not appreciate a need to collect and process elaborate information/data for supporting their credit decision making framework. Over time, as banking activities diversified and became more complex and the products became more sophisticated, risks also increased and became more complex. Although, the risks from intermediation became more transmitive and contagious, the evolution in the credit risk management failed to keep pace. The advanced credit risk management necessitated a granular analysis of the risks that the banks were being exposed to; however, they failed to appreciate these requirements and relied on a primitive management information system. The failure of the banks to collect and analyze granular data/ information on various elements of credit risk is one of the major reasons why the banks failed to foresee the impending problems.

1.4 ASSET QUALITY MANAGEMENT IN BANKS

The quality of a bank's loan portfolio can impact its profitability, capital and liquidity. Asset quality problems are at the root of other financial problems for banks, leading to reduced net interest income and higher provisioning costs. If loan losses exceed the Bad and Doubtful Debt Reserve, capital strength is reduced. Reduced income means less cash, which can potentially strain liquidity. Market knowledge that the bank is having asset quality problems and associated financial conditions may cause outflow of deposits. Thus, the performance of a bank is inextricably linked with its asset quality. Managing the loan portfolio to minimize bad loans is, therefore, fundamentally important for a financial institution in today's extremely competitive and market driven business environment.

The general perception about a bank's health is greatly determined by the level of Non-performing Advances (NPAs) held in its books.

Management of NPAs begins with the consciousness of a good portfolio, which warrants a better understanding of risks in lending. The Bank has to decide a strategy keeping in view the regulatory norms, the business environment, its market share, the risk profile, the available resources etc. The strategy should be reflected in approved policies and procedures to monitor implementation. The essential components of sound NPA management are: (i) quick identification of NPAs, (ii) their containment at a minimum level and (iii) ensuring minimum impact of NPAs on the financials. A two-pronged strategy of preventing slippage of standard assets into NPA category and reducing NPAs through cash recovery, upgradation, compromise, legal means etc., is called for.

RECENT RECOMMENDATIONS OF RBI TO EARLY RECOGNISE THE FINANCIAL DISTRESS; PROMPT STEPS FOR RESOLUTION AND FAIR RECOVERY FOR LENDERS

The paper released by RBI proposes that with the slowdown of the Indian economy, a number of companies/projects are under stress. As a result, the Indian banking system has seen increase in NPAs and restructured accounts during the recent years. Not only do financially distressed assets produce less than economically possible, they also deteriorate quickly in value. Therefore, there is a need to ensure that the banking system recognises financial distress early, takes prompt steps to resolve it, and ensures fair recovery for lenders and investors (DNA, 2013).

1.4.1 The Main Proposals of the Paper are

- Early formation of a lenders' committee with time lines to agree to a plan for resolution.
- Incentives for lenders to agree collectively and quickly to a plan better regulatory treatment of stressed assets if a resolution plan is underway, accelerated provisioning if no agreement can be reached.
- Improvement in current restructuring process: Independent evaluation of large value restructurings mandated, with a focus on viable plans and a fair sharing of losses (and future possible upside) between promoters and creditors.
- More expensive future borrowing for borrowers who do not co-operate with lenders in resolution.
- More liberal regulatory treatment of asset sales.
- Lenders can spread loss on sale over two years provided loss is fully disclosed.
- Takeout financing/refinancing possible over a longer period and will not be construed as restructuring.
- Leveraged buyouts will be allowed for specialised entities for acquisition of 'stressed companies'.
- Steps to enable better functioning of Asset Reconstruction Companies mooted.
- Sector-specific Companies/Private equity firms encouraged to play active role in stressed assets market.
- Going forward, while some regulatory and governmental measures may be required to address the factors that are leading to deteriorating asset quality, there is an equal need for proper credit discipline among lenders. That is, however, not the focus of this Paper.

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