

Reading the NPA tea leaves

By: [FE Bureau](#) | New Delhi | Published: May 22, 2018 3:30 AM



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Non-performing assets (NPAs) have been in the news for a long time. The Financial Stability Report of [RBI](#), December 2017, points out that the gross non-performing advances (GNPA) ratio of scheduled commercial banks (SCBs) increased from 9.6% to 10.2% between March and September 2017. The GNPA grew by 18.5% on a year-on-year basis in September 2017. While the GNPA of public sector banks (PSBs) stands at 13.5% in September 2017, the figure stands at 3.8% for private banks.

Many reasons have been ascribed to the spurt in NPAs. First, majority of the projects were sanctioned in the boom phase of economic growth. Both corporates and banks were optimistic it would be a win-win for all. However, as slowdown ensued, their assumptions collapsed. Many infrastructure projects got stalled for reasons like the so-called policy paralysis, pending court cases, and regulatory issues like environmental clearances and corruption. The stalled projects, therefore, failed to generate cash flows and corporates failed to repay loans. As a result, NPAs started to rise. Second, crony capitalism aggravated NPAs. Bank boards with political connections might have got undeserving loans. In a classic case of “moral hazard,” politically-connected corporates know that even if they default, banks would be recapitalised by the government using taxpayer money. This results in wilful default by some corporates. Third, banks are responsible for their poor monitoring and supervision, and awful credit appraisal and lending practices also led to accumulated bad debts. This points to the perceived ineffectiveness of RBI’s supervisory architecture in controlling the situation on time.

The negative repercussions of NPAs on the economy are way too many. One, NPAs invariably raise lending rates. The interest rate charged by SCBs consists of policy rate (repo rate), a default risk premium, a term premium, an inflation risk premium, and the bank's compensation for costs. For example, if a commercial bank's lending rate is 15%, of this 6% is due to policy rate and the rest 9% is due to other four factors. It is important to remember that the rest of the four factors or additional 9 percentage point rate of interest is independent of monetary policy. Banks charge the default risk premium because of the uncertainty on repayment of loans. Given that banks knew about the quality of loans much before they went to the less informed customers (adverse selection), they also increased credit risk and, as a result, lending rate increased adverse selection.

Two, by RBI's own admission in a recent paper (Asset Quality and Monetary Transmission in India), huge NPAs weaken the monetary policy transmission mechanism. For instance, between January and October 2015, RBI, in its various policy reviews, reduced the repo rate by 125bps. But banks did not pass the benefits to the customers, who got benefit only by 50bps, i.e. the amount of reduction in lending rate by most SCBs, while the deposit rate was reduced sharply, by 130bps. As a result, net interest margin rose, which is one of the highest in the world. Thus, banks are using the policy rate to their advantage from both ends: deposit and lending rates. A 2015 IMF working paper by Sonali Das showed that pass-through of policy rate changes to bank interest rates in India is slow and adjustment is asymmetric. That is, when policy rate rises, the deposit rate does not adjust to it, while the deposit rate adjusts faster to monetary policy easing. Further, bank lending rate moves more closely and faster with response to monetary policy tightening than to loosening. One reason could be that high levels of NPAs held by banks limits their ability to pass on the full benefits of monetary easing. In a way, banks are trying to recover their loss from the repo rate cuts.

Three, NPAs lower private investment. Investment drops as interest rate goes up. Importantly, corporate investment is not greatly affected by meagre interest rate changes. We think slowdown in the credit growth is largely due to stress in PSBs. This

makes overburdened PSBs cautious and risk-averse to more lending. Banks expect a correction in credit lending after a lending spree. They have become cautious and selective in sanctioning new loans. Given that economic growth has slowed down, they fear businessmen might not be able to make good profit and, thus, may not be able to repay debt, which, in turn, leads to low investment. Further, more NPAs mean more capital they have to keep separately to meet the Basel III capital norms.

Four, huge NPAs lead to banking crises, too. At `4 lakh crore, bad loans exceed the market value of PSBs by 1.5 times. This will scare equity investors as they fear it may explode any time and the economy will nosedive. As banks report higher NPAs, bank stocks will be hit and retail investors will be affected. Therefore, the government is recapitalising with a fear that a failed banking system may exacerbate financial crisis and economic meltdown. However, a timely intervention by RBI and the government has averted the crisis.

Five, rising NPAs may lead the rating agencies to downgrade ratings of PSBs and private banks; it will affect their ability to raise capital. Finally, an NPA is a double whammy for (retail) investors. On one hand, they lose money as share prices of banks fall, and on the other, as taxpayers, they've to pay taxes to recapitalise banks.

NPA crises call for more bank autonomy. PSB boards should be full of professionals with full autonomy. Better corporate governance and decentralisation will help improve loan evaluation, monitoring, repayment. Politically-connected lending must be a no-no. In this regard, the Insolvency and Bankruptcy Code, 2016, is a step in the right direction. We hope RBI and the government's efforts of cleaning up of banks' balance sheets succeeds and credit growth to the business sector revives.

By Santosh Kumar Dash & Sitakanta Panda. Dash is researcher, Centre of Excellence in Fiscal Policy and Taxation, Bhubaneswar; Panda is assistant professor of Economics, IIM Amritsar. Views are personal.

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