

NPA crisis: Relaxing Prompt Corrective Action would mean a bigger bailout

Updated: November 28, 2018 7:24 AM

Unless early intervention is exercised by the regulator, the 'undercapitalised' banks may quickly turn into significantly or critically undercapitalised banks



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By, Barendra Kumar Bhoi

India's banking system is passing through a critical time due to the overhang of large non-performing assets (NPA). Efforts are being made by [RBI](#) and the Union government to resolve the problem through multiple initiatives. The

resolution mechanism has been strengthened by enacting the Insolvency and Bankruptcy Code (IBC), 2016. The National Company Law Tribunal (NCLT) is being harnessed for the resolution of NPA cases involving large borrowers in a time-bound manner. Unless corporate sector balance sheets are cleaned up, it would be difficult for commercial banks to resolve the NPA problem on an enduring basis.

Ever-greening of non-performing loans, typically pursued by commercial banks, received a major boost as RBI relaxed asset classification norms by treating restructured loans as standard assets after the global financial crisis. Taking advantage of the regulatory forbearance, commercial banks did not flag NPAs until this relaxation was withdrawn in April 2015. Asset Quality Review (AQR), implemented since the second half of 2015, revealed the true magnitude of the NPA problem. The gross NPAs of scheduled commercial banks (SCBs), which was 4.3% (Rs 3.2 trillion) in March 2015, rose to 11.2% (Rs 10.4 trillion) in March 2018. The problem has been more severe for public sector banks (PSBs) with gross NPAs ratios surging from 5% (Rs 2.8 trillion) to 14.6% (Rs 9 trillion) during the same period.

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RBI tried to resolve the NPA problem through several initiatives, including flexible debt restructuring, special debt restructuring, scheme of sustainable structuring of stressed assets, etc. As these experiments, by and large, failed to produce tangible results, RBI scrapped all these initiatives and issued revised guidelines on February 12, 2018, for early resolution of stressed assets. If

borrowers and lenders fail to arrive at suitable resolution plans within the specified time limit, NCLT would be the main tool for legal resolution of NPAs involving big defaulters under IBC.

If loan loss provision as proportion to gross NPAs is 100%, there would be the least risk to capital erosion in case of loan write-off. In India, the provision coverage ratio (PCR) has been historically low, although this ratio has improved marginally at the aggregate level in the post-AQR regime. As against the desirable PCR of 70%, PSBs had hardly achieved 47.1% by March 2018, while foreign banks clocked 88.7% and private sector banks 51%.

Two major initiatives to resolve the NPA problem have been the recapitalisation of PSBs by the government and the Prompt Corrective Action (PCA) by RBI. In October 2017, the government announced a Rs 2.11-trillion recapitalisation package for PSBs, of which Rs 1.53 trillion would be government capital infusion and the balance was to be raised from the market. As the government has a budget constraint, it would be difficult to infuse capital frequently. There is a moral hazard problem, too, as repeated capital infusions by government may serve as reward for inefficiency in PSBs. Going to the market for recapitalisation with weak balance sheets is not a prudent move either, particularly when equity market is under pressures due to external headwinds such as rise in crude oil prices, capital flight from EMEs, intensification of a trade war, and normalisation of monetary policy by developed countries.

According to the revised guidelines on PCA issued by RBI on April 13, 2017, the regulator has imposed certain restrictions on banks, whose capital, asset quality and profitability do not meet pre-specified thresholds. Currently, eleven

PSBs and one private sector bank are under PCA. Mandatory actions include, inter alia, restriction on dividend distribution, infusion of capital by promoters/owners, restriction on branch expansion, higher provisioning requirement, restriction on management compensation, etc. While no restriction has been imposed on retail deposit-taking activity, banks under PCA are advised to refrain from taking high-cost bulk deposits.

Under PCA, a major restriction relates to balance sheet expansion, particularly with regards to the credit portfolio. This is unpleasant but inevitable till balance sheet health is restored. PCA banks may have to deploy their deposit resources predominantly in sovereign papers, where the credit risk is zero. Incidentally, the share of PCA banks in advances and deposits of SCBs was 18.5% and 20.8%, respectively, on March 31, 2018, and their credit growth has continued to remain negative since 2016, partly due to loan write-offs and conversion of credit to investment under the UDAY scheme. However, fresh lending could be done against write-offs of those NPAs for which 100% provisions have been made without breaching regulatory restrictions on balance sheet. Despite asset growth restriction on PCA banks, SCBs' recent non-food credit growth has improved to double digits due to non-PCA banks meeting bulk of the pick-up in credit demand.

The merger of banks is often advocated as an alternative resolution mechanism. A strong bank is expected to assume the deposit liability of the weak bank at the negotiated valuation of its standard and sub-standard assets. There have been 22 mergers in India's banking industry since 1991, of which 11 have been compulsory mergers under Section 45 of the Banking Regulation Act, 1949. As NPAs are currently a systemic problem, all PSBs are considered

weak; the degree of weakness being different amongst PSBs. Hence, pursuing bank merger may not be advisable at this point of time.

According to early indications, further deterioration of critical parameters of PCA banks has been arrested. Banks under PCA have to bear with the bitter medicine, which may take time to restore their health. Unless early intervention is exercised by the regulator, the 'undercapitalised' banks may quickly turn into 'significantly undercapitalised' and 'critically undercapitalised' depending on thresholds of capital erosion. If imposition of regulatory discipline is delayed/relaxed without improvement of the asset quality, a bigger bailout by the government may be required to protect the interest of depositors as PSBs are too big to fail.

The writer is Visiting fellow at IGIDR and former principal adviser and head of the monetary policy department of RBI

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