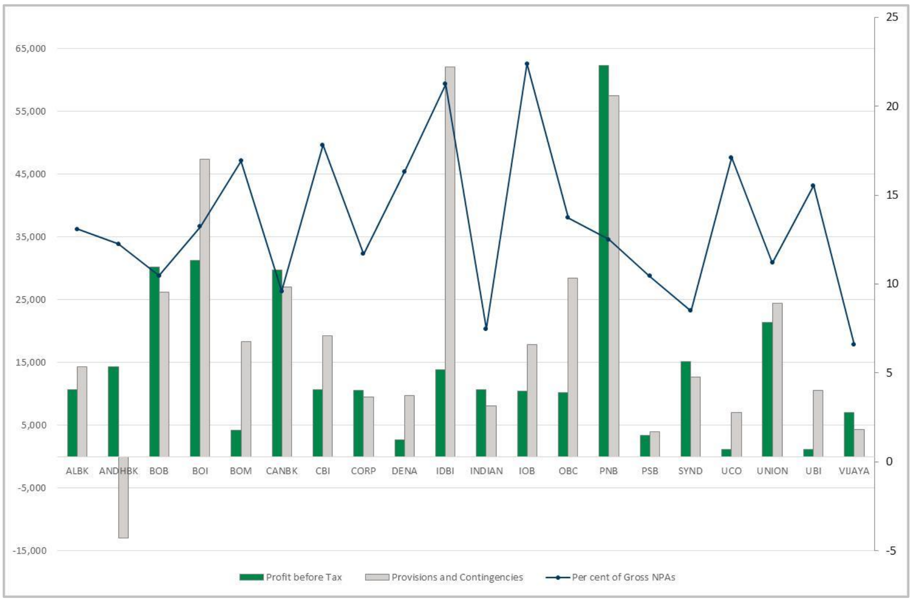
NPAs in India: Recovering from the Stress

Rising stressed assets continue to cast a shadow over the financial health of the Indian banking system and as an extension, on the growth rate that can be achieved by the Indian economy. This is clearly evident from the sharp growth in Gross Non-Performing Assets (“GNPAs”) from 5.1 percent in September 2015 to 9.6 percent in March 2017.[1] The higher provisioning for Non-Performing Assets (“NPAs”) in recent years has not only impacted profitability of banks in India, but has also reduced the funds available to customers. As demonstrated in the graph below, 20 public sector banks (excluding State Bank of India) have made provisions of INR 395,839 million (USD$6,169 million), which is approximately 131 percent of operating profits reported for the quarter ending March 2017, with an average GNPAs of 13.4 percent.[2]



[1] Financial Stability Report, June 2017, Reserve Bank of India
[2] Financial Results available on the website of Bombay Stock Exchange, India

Impairment Woes

Raghuram Rajan, former Governor of the Reserve Bank of India (RBI),[3] cited "global financial crisis and malfeasance" as primary factors that resulted in an increase in the level of NPAs in India. Though the financial crisis adversely impacted all sectors, certain industries such as infrastructure, iron and steel, power and textiles suffered due to frequent regulatory hurdles, delays in land acquisition, project cost over-runs and fluctuating commodity prices. Consequently, numerous companies operating in these sectors began defaulting on debt repayments. Over time, these defaults have contributed significantly to the spiraling NPAs. In addition to unfavourable business conditions, dishonest borrowers and unsuspecting lenders have also been major contributors to rising NPAs in India. According to a report published by the Standing Committee on Finance (2015-16),[4] "diversion of funds by promoters to unrelated businesses and poor pre-sanction due diligence were key reasons for bank loans turning toxic."

Reforms to Revive: Limited Gains

Historically, the government and RBI have announced various steps to assist banks in the management and recovery of stressed assets. One of these steps included the introduction of the SARFAESI Act[5] in 2002, which allowed banks to refer cases to Lok Adalats[6] and Debt Recovery Tribunals[7] for the recovery of outstanding dues. Nevertheless, banks were able to recover only 15 percent of INR 7,491 billion (USD$117.04 billion) from over 10 million cases referred between financial years 2012-13 and 2015-16.[8]

Given this low recovery rate of outstanding dues, RBI introduced new schemes, such as Strategic Debt Restructuring ("SDR") and Scheme for Sustainable Structuring of Stressed Assets ("S4A"), to further empower banks to resolve the growing crisis of NPAs. However, only a handful of cases have been successfully resolved under these schemes. Providing an explanation for the lack of successful resolutions under SDR and S4A schemes, the Economic Survey for 2016-17 stated that viability issues pertaining to companies' operations, acute coordination failures amongst creditors, insufficient capital and threat of subsequent investigations on banking officials are some of the reasons for the inability of the Indian banking system to resolve stressed assets.

Recognising that reforms in the bankruptcy and insolvency regime are critical for improving the business environment in India, the government in May 2016, introduced the Insolvency and Bankruptcy Code ("IBC"). The objective of the IBC is to consolidate insolvency legislative framework and ensure a time-bound resolution aimed at maximising the value of assets involved in a dispute between banks and borrowers. However, bankers were reluctant to refer cases under IBC as they feared the proceedings might increase the number of cases involving liquidation of companies and lead to lower recoveries.

In order to overcome the aforementioned shortcomings, in May 2017, the government empowered RBI to issue directions to the banks for the resolution of stressed assets, including the recommendation to initiate an insolvency resolution process under the IBC. In June 2017, RBI recommended the banks to refer 12 NPAs, which constituted 25 percent of the current GNPAs, for immediate resolution under the IBC. Even though the lenders have an additional layer of protection in the form of RBI's internal advisory committee, they continue to face the challenge of distinguishing themselves between 'wilful defaulters' and other 'distressed borrowers'. This distinction has proved to be one of the biggest bottlenecks in the resolution process because bankers often lack sufficient information to make these decisions.

Uncover Information to Recover

Individual banks have visibility into transactions at their bank, but they have limited insight into a borrower's activities at other financial institutions. A common modus operandi used by dishonest borrowers is to create multiple layers of transactions using bank accounts held across different banks and channelise funds to related parties. Without the availability of a centralised database for transactions, such transactions are beyond the monitoring controls implemented individually by any bank in India. In cognizance of the above, the Corporate Debt Restructuring Cell[9] recommends conducting 'forensic/special investigative audit' of the defaulter's book of accounts to gain a comprehensive understanding of its banking relationships and financial health prior to referring a case for debt restructuring.[10]

Undertaking a forensic audit of stressed accounts will assist banks in discerning the underlying reasons behind the loan default while identifying indicators for potential diversion and siphoning of funds. When conducted simultaneously with a business intelligence exercise into the borrower's business activities, in addition to identifying factors contributing to a loan default, a forensic audit can assist bankers in recommending a case for restructuring as well as provide pressure points for more constructive negotiations.

[3] India's central banking institution, the Reserve Bank of India (RBI), is the regulator and supervisor of the financial system and prescribes broad parameters of banking operations within which the country's banking and financial system functions.
[4] Report on Non-Performing Assets of Financial Institutions, February 2016
[5] The SARFAESI Act, 2002 allows banks and other financial institution to auction residential or commercial properties to recover loans.
[6] Lok Adalat is one of the alternative dispute redressal mechanisms, where disputes/cases pending in the court of law or at pre-litigation stage are settled/ compromised amicably.
[7] Debt Recovery Tribunals provide expeditious adjudication and recovery of debts due to banks and other financial institutions.
[8] Statistical Tables Relating to Banks in India (STRBI) 2014-15, Reserve Bank of India

[9] Third tier of Corporate Debt Restructuring Mechanism in India, Corporate Debt Restructuring Cell is the authority to whom all references for corporate debt restructuring are made by lenders and borrowers.
[10] Corporate Debt Restructuring Master Circular, as updated on 29 April 2015

How FTI Consulting Can Help

Through our extensive experience, FTI Consulting is well-positioned to provide critically needed advice and assistance at each stage of lending and recovery.

Pre-Lending	Stressed Asset	Non-Performing Asset	Recovery & Restructuring
Business Intelligence and Asset Tracing			
Risk-based due diligence	**Forensic Accounting**		
Collateral Analysis and Diligence	**Fraud Investigations**		

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