Problem Loan Management & MSME Financing

I am very glad to be talking to you on a subject which is very contemporary and very critical for the economy. Both the Government of India and the Reserve Bank have long been convinced of the contribution, and of the enormous potential, of the SME sector to the economic growth, employment and income generation for vast masses of the country. Recent Government pronouncements about “Make in India” are fundamentally based on these convictions. Therefore, detailed discussions and debate on the ways, procedure, precautions and follow-up on SME financing are very apt and timely. I appreciate the efforts of CRISIL and others in this regard. I understand that in this workshop you all had discussed about SME Loan Life Cycle Management, Credit Scoring as a technique for credit appraisal, strategies and tools to monitor SME loans and handle problem SME loans, including building early warning systems, etc. I am sure all of you have been benefited by these discussions. Let me dwell a bit more on the problem loan management, as currently it is a serious issue for the banking sector.

Asset Quality

2. Asset quality is an important parameter to measure the health of the banks. In the last twenty years or so, the Gross Non-Performing Asset Ratio as well Net Non-Performing Asset Ratio of Indian banks have been showing a declining trend due to many factors, and very significantly due to the sustained improvements in the credit risk management practices adopted by the banks. The gross non-performing assets (NPAs), in percentage terms, have declined steadily from 15.70% at end March 1997 to 2.35% at end March 2011. However, asset quality of the banking system has suffered significant deterioration in the recent years. NPAs expressed in terms of Gross NPA Ratio increased to 4.11% at the end of March 2014. During the period, the ‘restructured but standard loans’ (restructured in terms of regulatory dispensation provided to banks for supporting viable accounts facing temporary difficulties and in line with public policy imperatives) as a % of gross advances increased considerably from 1.14% in March 2008 to 5.87% in March 2014. There has been further deterioration in asset quality during March to September 2014 and the GNPA ratio and restructured advances ratio

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increased to 4.54% and 6.13% respectively at the end of September 2014. As such, the overall stressed advances (NPAs + Restructured advances) remained high with considerable increase in the recent period working out to 10.67% for the banking system as at the end of September 2014. In terms of value, with Gross NPAs at ₹2798 billion and Restructured standard advances at ₹3780 billion, the total stressed advances amounted to ₹6578 billion at the end of September 2014.

Stressed Sectors

3. Based on the levels of stress in different sub-sectors, it was observed that (i) 'infrastructure' (ii) 'Iron and Steel' (iii) Textiles (iv) Mining (including Coal) and (v) Aviation services had significantly higher level of stress and thus these sub-sectors / segments could be taken as 'stressed' sectors in the current scenario.

Macro-Stress tests

4. Macro-stress tests are conducted by the Reserve Bank of India to ascertain the resilience of banks against macroeconomic shocks. The results of this analysis presented in the Financial Stability Report-December 2014, suggest that under the baseline scenario, the GNPA ratio is expected to be around 4.0% of total advances as at the end of March 2016. However, if the macroeconomic conditions deteriorate, the GNPA ratio may increase to 6.3% under severe stress scenario by March 2016.

Drivers for deterioration in Asset Quality

5. Theoretically speaking, there could be various factors which may cause a good loan to turn into a problem loan. Some of the external reasons could be economic recession, non-payment in other countries, inputs / power shortage, price escalation, accidents / natural calamities, and changes in government policies in excise / import duties, pollution control norms, delay in disbursal of loans by lenders, etc. Internal reasons for loan accounts becoming problem loans could be diversion of funds for expansion / diversification / modernization / for taking up new projects, for helping / promoting associate concerns, time / cost overrun during the project implementation stage, business (product, marketing, etc.) failure, inefficient management, strained

labour relations, inappropriate technology / technical problems, and product obsolescence, etc.

6. The current deterioration in the asset quality of Indian banks could mainly be attributed to domestic and global economic slowdown, delays in statutory and other approvals, especially for projects under implementation, relatively aggressive lending practices during upturn (2003-08), as evidenced from high corporate leverage, risk concentration, especially to large greenfield projects, and of course, lax risk management systems of banks, etc.

NPA Management

7. Managing NPAs has a lot to do with managing productive assets and ensuring effective corporate governance. Management of NPAs begins with the realisation of benefits that accrue in running a quality advances portfolio and warrants a better understanding of risks in lending. The Board of Directors has to decide a strategy on NPA management keeping in view the regulatory norms, the business environment, the asset profile, the available resources, etc. The strategy should be reflected in Board approved policies and procedures to monitor implementation.

8. The essential components of sound NPA management are:

i) Prevention of NPAs through prudent underwriting
ii) Effective early alert system
iii) Quick and effective remedial measures to prevent slippage
iv) Faster resolution of post slippage

9. A multi-pronged strategy of preventing slippage of standard assets into NPA category and reducing NPAs through cash recovery, up gradation, compromise, legal means etc., is called for.

Restructuring

10. Generally, stress in borrowal accounts is more likely to be resolved in terms of recovery if the company is in operation. For this to be effective there must be a system of identifying the weakness in accounts at an early stage. Banks should put in place an 'Early Alert' system that captures early warning signals in respect of accounts showing first signs of weakness. This would help the banks to take remedial measures and prevent the account from becoming NPA. Banks may restructure / reschedule the accounts of viable entities and assist the entity to tide over the temporary difficulties faced by them.

11. Once a weak account is identified, the bank needs to consider various corrective actions. One of the corrective options is restructuring. In spite of their best efforts and intentions, sometimes borrowers find themselves in financial difficulty because of factors beyond their control and also due to certain internal reasons. For the revival of the viable entities as well as for the safety of the money lent by the banks, timely support through restructuring in genuine cases is called for. The objective of restructuring is to preserve the value of viable entities that are affected by certain internal and external factors and minimize the losses to the creditors and other stakeholders. We already have a detailed regulatory prescription, separately for Corporate Debt Restructuring mechanism for consortium advances and standalone restructuring by individual banks.

12. The objective of the Corporate Debt Restructuring (CDR) framework is to ensure timely and transparent mechanism for restructuring the corporate debts of viable entities facing problems, outside the purview of BIFR, DRT and other legal proceedings, for the benefit of all concerned. In particular, the framework aims at preserving viable corporates that are affected by certain internal and external factors and minimize the losses to the creditors and other stakeholders through an orderly and coordinated restructuring programme. The CDR Mechanism has been designed to facilitate restructuring of advances of borrowers enjoying credit facilities from more than one bank / Financial Institution (FI) in a coordinated manner.

Framework for Revitalising Distressed Assets

13. The Reserve Bank of India has released in early 2014 a Framework for Revitalising Distressed Assets in the Economy. The Framework outlines a corrective action plan that will incentivise early identification of problem cases, timely restructuring of accounts which are considered to be viable, and taking prompt steps by banks for recovery or sale of unviable accounts. The main features of the Framework are:

i) Central Repository of Information on Large Credits (CRILC) has been set up by RBI to collect, store and disseminate credit information with the reporting entities in respect of borrowers enjoying aggregate exposure (funded + non funded) of ₹50 million and above.

ii) Early formation of a lenders' committee (Joint Lenders Forum) with timelines to agree to a plan for resolution; mandatory beyond the exposure of ₹1000 million and above. The Corrective Action Plan may include any one of the following:
   a) Rectification
   b) Restructuring
   c) Recovery

iii) Incentive and disincentive structure for lenders to take corrective actions in a timely manner

iv) 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.

v) 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.

vi) More expensive future borrowing for borrowers who do not co-operate with lenders in resolution.

Support to viable but stressed Accounts

14. Despite the best efforts by banks, slippages do occur. Once an account slips into NPA category, then the focus should shift to upgradation. At this juncture, it is important to understand that the Reserve Bank has not barred banks from sanctioning need based additional finance to borrowers whose accounts are classified as NPAs. On the contrary, Reserve Bank's extant guidelines envisage a situation where banks may need to sanction additional finance to borrowers under stress to revive / rehabilitate the borrower and to preserve the economic value of the asset. Mere classification of an account as NPA need not result in withdrawal of support to viable borrowal accounts. However, while considering their support to accounts under stress, banks should make proper distinction between wilful-defaulters / non-cooperative / unscrupulous borrowers on the one hand, and, on the other hand, borrowers defaulting on their debt obligations due to circumstances beyond their control.

Sale of NPAs

15. In the event of failure of the above mentioned measures, banks could resort to filing suits with Debt Recovery Tribunals or invoke the provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002. Banks may also sell their NPAs to asset reconstruction companies. The RBI has granted Certificate of Registration (CoR) to 14 ARCs so far. In addition to asset reconstruction companies, banks may also explore selling the NPAs to other banks, non-banking finance companies or other financial institutions, who have the requisite skills to resolve the NPAs efficiently. In February 2014, regulations on sale of stressed accounts have been amended to facilitate emergence of a market for distressed assets.

Recovery Channels

16. Despite various corrective measures, if upgradation is not proving to be possible due to unviable nature of the borrowers' business, the bank should take steps to recover the loans through any of the recovery options available to them. Among the various channels, the amount of NPAs recovered under the SARFAESI Act, 2002

formed almost 80% of the total amount of NPAs recovered in 2013-14. The SARFAESI Act has, thus, been the most important means of recovery of NPAs.

NPAs of SCBs Recovered through Various Channels						
(Amount in ₹Billion)						
			Recovery Channel			
Year	**No.**	**Particulars**	**Lok Adalats**	**DRTs**	**SARFAESI Act**	**Total**
2012 - 13	1	No. of cases referred	8,40,691	13,408	1,90,537	10,44,636
	2	Amount involved	66	310	681	1,058
	3	Amount recovered*	4	44	185	232
	4	3 as per cent of 2	6.1	14.1	27.1	21.9
2013 - 14	1	No. of cases referred	16,36,957	28,258	1,94,707	18,59,922
	2	Amount involved	232	553	946	1,731
	3	Amount recovered*	14	53	244	311
	4	3 as per cent of 2	6.2	9.5	25.8	18

Notes : 1. * : Refers to amount recovered during the given year, which could be with reference to cases referred during the given year as well as during the earlier years.
2. DRTs: Debt Recovery Tribunals.

17. However, the present legal system is unable to cope with the mammoth task, considering the ever increasing number of suits and the limited infrastructure available at DRTs / courts. Further, there are various issues relating to DRT and SARFAESI, which needs to be strengthened to make these channels more efficient and effective. They are being examined at various levels.

18. Banks also explore entering into a compromise settlement / one time settlement with the borrower to optimise its recovery in present value term.

MSME Financing

19. As this workshop was meant to specifically discuss SME financing, let me share a few thoughts on this matter.

20. As I mentioned in the beginning, Micro, Small and Medium Enterprises (MSMEs) play a major role in economic development, particularly in emerging countries. There is heightened attention by the international community on MSME sector. This is primarily because of the critical importance of job creation in the recovery cycle following the recent financial crisis, and the MSME's potentials in that respect.

21. Yet, lack of access to finance is a major obstacle to their growth. Although the situation can differ among countries and individual businesses, the financing gap for SMEs in the developing country has a few well-accepted causes. These include Information asymmetries, higher risks, Sizeable transaction costs and a lack of adequate collateral. These factors can be exacerbated by institutional factors within a country. Finally, there are a number of "demand side" considerations that deserve more attention.

22. The following three factors play a considerable role in perpetuating the MSME financing gap - The poor quality of projects seeking funding, the inability of MSMEs to make the best possible use of available resources of funding and the negative attitude displayed by MSMEs towards equity financing.

23. Unfortunately, there is no authentic data available about the SME financing gaps. The informal segment within the SME sector is so vast and, by definition, no authentic information about them is available. However, various data sources and studies indicate that most of the small firms rely on internal financing and informal sources.

24. A study by the IFC and McKinsey and Company (McKinsey) suggests that there are close to 365-445 million micro, small, and medium enterprises in emerging markets of which 25-30 million are formal SMEs and 55-70 million are formal micro enterprises, while the rest (285-345 million) are informal enterprises. According to the same study, close to 45 to 55% of the formal SMEs (11-17 million) in the emerging markets do not have access to formal institutional loans or overdrafts despite a need for one. The finance gap is far bigger when considering the micro and informal enterprises; 65-72%

of all MSMEs (240-315 million) in emerging markets lack access to credit. The size of the finance gap varies widely across regions and is particularly daunting in Asia and Africa. Some studies about SMEs in India have reported that as high as 93% of their financing needs are met by internal and informal sources.

25. In order to scale up the best practices in SME Finance, the G-20 SME Finance Sub-Group executed a global SME Finance stocktaking exercise with various SME finance models. This exercise entailed the collection of 164 SME finance models spanning across a broad spectrum of interventions, including: (i) legal and regulatory framework; (ii) financial information infrastructure; (iii) public support schemes; and (iv) private sector initiatives. The stocktaking exercise confirms the rise in various parts of the world of specific business models aimed at providing financial services to SMEs in a cost-effective manner. From microfinance up-scaling to bank down-scaling, including community banks, these models share common characteristics: they reduce cost to serve through intensive use of technology and / or the adoption of cost-effective client-relationship models; they combine offering of savings, transactional, and credit products, with a view to increase generated income; they use advanced risk management technology to maximize the risk / reward balance; and, they achieve strong focus on the small and / or medium enterprise segment, to help implement excellent execution capabilities in the above areas.

26. Hence, the key challenge is to support banks in extending credit facilities to SMEs. It will be a greater challenge to reach informal SMEs. This is due to SME intrinsic weaknesses, flaws in delivery models and, most importantly, lingering deficiencies in the enabling environment for financial services: i.e. the financial infra-structure covering accounting and auditing standards, credit reporting systems, and collateral and insolvency regimes.

Some other ideas

27. In this workshop, you all had detailed deliberations on how to assess credit needs of an SME, how to monitor the relationship and what new techniques you can adopt for this. Let me give you a flavour of ideas beyond this:

i. Reaching informal businesses will have to be built on microfinance approaches. It all has to start with account relationship. The financial inclusion programmes like PMJDY will facilitate key information inputs to banks about the existence of the MSMEs, whether in formal and in informal segments. Banks should leverage these data and information feeds to identify potential MSMEs for suitable financing opportunities.
ii. Banks will also need to develop ingenious and innovative products suitable for the MSMEs. I strongly believe that this aspect needs to be grounded more at the grass root level. Based on broad parameters given by their central / head offices, the actual packaging of the products and services will have to happen closer to the field. Key elements of such packaging will have to include Risk-sharing facilities.
iii. Banks will also have to play a much larger role than being the financiers. MSMEs often lack management skills, tools, governance and financial pla nning expertise. Banks will have to help these entrepreneurs leverage the RSETI like institutions to fill the gaps.
iv. Another major weakness that inhibits the growth of this sector is the lack of good records management by the MSMEs; this often results in poor credit ratings and a perception of risky business. Some innovative solutions using cloud computing have been tried successfully in some countries like Ghana. Perhaps this can be studied and adapted for Indian environment.

28. These interventions need to be accompanied by enhancements to the enabling environment for MSME lending, such as improved credit bureaus, and collateral and insolvency regimes. For the success of effective SME financing models, it is imperative that suitable supporting environment for the financial sector is in place. In particular, financial information and the ability to enforce collateral are seen as critical necessities. Weaknesses in these areas appear to impede more aggressive financial services growth in developing markets.

29. We are very aware of these requirements and have taken several measures in that direction. Our recent guidelines, based on Aditya Puri Committee recommendations, envisage that credit information now will flow to all credit bureaus simultaneously and therefore the financial entities can have a holistic view about any prospective borrower at one go. As regards collateral registry, steps have been initiated in this direction. The Central Registry of Securitisations, Asset Reconstruction and Security Interest of India (CERSAI) has come on the scene for registering security interests over property. Other types of registry and inter-linking registries are also being debated. As regards insolvency, especially for MSMEs, as announced in the last Budget, a Committee is working out an insolvency framework.

30. Public support schemes (funded facilities, guarantee schemes, and state banks) represent the large majority of the collected models. India has also adopted these strategies. CGTSME, MSME lending as a priority sector lending for banks etc measures have been in line with this thought.

31. Although MSME financing and microfinance models have started yielding desired results, equity financing remains a challenge. Given that banking and lending services represent the bulk of SME financing in the developing world, especially for small firms, equity financing presents an opportunity for the development of a complementary financial product.

Conclusion

32. To conclude, let me emphasize that increasing access to finance can only be successful if qualitative aspects are taken into account. Adhering to principles of responsible finance and the G-20 principles on innovative financial inclusion can serve this purpose. It should also be noted that although financial access is critical for MSME growth, expansion of financial access should not be achieved at the cost of financial stability. Appropriate prudential measures need to be exercised while offering finance to MSMEs, in order to avoid the potential pitfalls stemming from excessive credit.

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