*Asset Quality Challenges in India: Diagnosis and Prognosis**

S. S. Mundra

Shri Rashesh Shah, Chairman and CEO - Edelweiss Group; members of the finance fraternity; delegates to the Conclave; ladies and gentlemen! It is indeed a pleasure to be here this morning. In my address, I primarily intend to focus on some of the contemporary issues around our banking sector that have come to dominate news rooms, court rooms, board rooms and drawing rooms alike. I am hinting at loud vilification of bankers and promoters without distinguishing between the victim and the black sheep. This is not an endeavor to bat for either the banks or the promoters but only an attempt to put the things in right perspective and to encourage an objective assessment of the situation. But before I do that, let me begin with some good news on the economic front.

2. Amidst the continued global sluggishness, domestic growth outlook remains positive for 2016-17 mainly on account of various structural reforms undertaken, expectations of a normal monsoon, easing of CPI inflation and rising private consumption. Focus on rural and social infrastructure sector and decline in subsidy outgo have resulted in improvements in the fiscal front, both quantitatively and qualitatively. Over the recent past, steel prices have strengthened both, globally and domestically, especially after introduction of the Minimum Import Price. Cement and auto sectors have also shown signs of growth pick up while the demand for oil has also increased by about 11 per cent in terms of quantity conveying some signs of buoyancy in economic activity in the country.

3. Let me now come to the main issue that I wanted to focus on this morning. What I am going to speak may sound like a medical script but that is how this story can be best described. I begin with talking about the symptoms of the disease that had shown signs of turning malignant.

Symptoms

4. The signs of rising stress in the banking system became increasingly evident in the years beginning 2012. The stressed assets (GNPA+ Restd. Std. assets +Written off Accounts) for the banking system as a whole, which stood at 9.8 per cent as at the end of March 2012, moved up sharply to 14.5 per cent as at the end of December 2015. During the same period, the stressed assets for the PSBs spiked from 11.0 per cent to 17.7 per cent.

5. Similarly, the growth in net profits of SCBs was also on a declining trend since 2011-12 and turned negative in 2013-14. This decline in net profits of SCBs during this period was primarily the result of higher provisioning on banks' delinquent loans during the period 2012-14. This in turn impacted their Return on Assets (RoA) and Return on Equity (RoE). The banks'

Return on assets and return on equity of SCBs: Bank group-wise

(Per cent)

Sr. No.	Bank Group/Year	Return on Assets			Return on Equity		
		2012-13	2013-14	2014-15	2012-13	2013-14	2014-15
1	Public sector banks	0.80	0.50	0.46	13.24	8.48	7.76
2	Private sector banks	1.63	1.65	1.68	16.46	16.22	15.74
3	Foreign banks	1.92	1.54	1.87	11.53	9.03	10.25
	All SCBs	1.04	0.81	0.81	13.84	10.69	10.42

Notes: Return on Assets = Net profit/Average total assets.
Return on Equity = Net profit/Average total equity.
Source: Annual accounts of respective banks.

* Keynote address delivered by Shri S. S. Mundra, Deputy Governor, Reserve Bank of India, at the Edelweiss Credit Conclave held in Mumbai on April 28, 2016.

spread and net interest margin (NIM) also witnessed a decline during the period.

Diagnostic or Root Cause Analysis

6. As in any medical exercise, the next step is to run a diagnostic check to understand the root cause of the problems. The asset quality problems can be fundamentally ascribed to one of the following four factors:

a) **Environmental factors**

The economic downturn that has engulfed the global economy since the onset of the Financial Crisis in 2008 can be counted as one of the major cause for the asset quality problems in India. Then, there are other external factors like fall in commodity prices, dumping by China *etc.* which has led to reduced competitiveness and consequently idle capacities and cash flow problems. The situation got aggravated due to the policy logjam that followed in the country. Several large scale projects in the country have remained stalled due to lack of environmental clearances, cancellation of coal block allocation, falling through of the fuel supply arrangements, local protests etc. Now, where do you bracket these promoters or the lending banks? Do you brand such promoters as wilful defaulters or such lenders as ill-motivated?

b) **Corporate Imprudence**

The imprudence of the corporates can be attributed as the second most important factor for poor asset quality in the system. Some of the major failings that the corporates exhibited are:

- Overleverage - All debt, no equity; Veiled corporate structures impeded assessment by banks.
- Obsession for higher growth- Excess capacities, Unrelated diversification. The liquidity generated due to ultra-accommodative monetary policy stance by Central Banks in advanced economies also created misaligned incentives.
- Chasing profits eg. ignoring risks inherent in unhedged forex exposures.

c) **Corporate Misdemeanors**

Not all promoters/borrowers have had a clear conscience and some of them were out to dupe the system by using foul means. They are willful defaulters in banks' books as they have been unwilling to honour their payment obligations even while having a capacity to do so. Some of the promoters have diverted borrowed funds for purposes other than for which the finance was availed. There are also occasions where some of the borrowers have siphoned off funds for personal gains and not created any productive asset. A section of the promoters have also disposed off movable fixed assets or immovable property given for the purpose of securing a term loan without the knowledge of the lender. The consequent defaults, in such cases are intentional, deliberate and calculated and hence willful. It is this set of promoters that need to be singled out and quickly brought to justice.

d) **Banks' failings**

It is not corporates alone that caused pain in the system. In several instances, the bankers have also not exercised due caution while conducting due diligence on the projects that they have financed. Some of the common shortcomings that the banks exhibited include:

- Governance deficit;
- Poor credit appraisal particularly in infra financing such as highways where contracts were 'gold plated'; Power which suffered from Faulty FSAs, absence of Pass through arrangements, lack of provision for termination payments etc.;
- Weak risk management;
- Chasing quick growth;
- Pretend and Extend

7. The mistakes committed by the banks and the corporates, whether incidental or intentional, have resulted in a massive pile up of non-performing assets in the banking system. While the banks needed to guard against growing credit concentration risks especially in sectors which had witnessed excessively high growth, the corporates should have had the foresight of analysing the emerging market dynamics. There was a general reluctance from the banking community to admit the level of stress in their books. It was built on the premise that NPAs are taboo and no one would be willing to lend to such accounts. Though, this perception has some real life truth, my question is should we not administer drug to the sick? Sometimes, there are overblown fears of unknown. If we don't address the stressed accounts, what are our alternatives? Company position would deteriorate further, hit banks' books and would still invite further scrutinies. Having said that, it is important to quickly decipher whether the disease is curable or terminal and also if curable, medicinal or surgical.

Pre-operative procedures

8. As any surgery is preceded by certain medication or other pre-operative procedure, here also, the RBI did prescribe them. It started with creation of the Central Repository of Information on Large Credits (CRILC) database which enabled compilation of information on level of indebtedness of various groups to the financial system. This was followed by issuance of Guidelines on 'Early Recognition of Financial Distress', Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalising Distressed Assets in the Economy by the RBI, which were aimed at improving the system's ability to deal with corporate and financial institution distress. Detailed Guidelines on formation of Joint Lenders' Forum (JLF), Corrective Action Plan (CAP), 'Refinancing of Project Loans', 'Sale of NPAs by Banks' and other regulatory measures were also issued to banks for enabling prompt steps for early identification of problem cases, timely restructuring of accounts considered to be viable and recovery or sale of unviable accounts. The 5/25 scheme and the Strategic Debt Restructuring scheme were also introduced with a view to enable reduction in stress levels and early resolution.

Surgical procedure

9. After the pre-operative procedures, the RBI undertook a surgical procedure in the form of Asset Quality Review (AQR) at banks. The exercise was aimed at tracing the sources of pain and pressure points so that remedial procedure could be administered. GOI must be complimented for extending total support by infusing capital /committing to infuse capital in the weaker PSBs.

10. Whether this surgery is successful? Did it have the desired impact? I would think so. In my interaction with various players, I sense it has a very positive impact, even in Tier II and Tier III towns. The promoters have realised that the banks are going to come hard after them if they don't observe credit discipline. Of course, there are skeptics who say whether it was the right time to the RBI to undertake this initiative especially at a stage when the economy is growing slowly. Interestingly, some of these are the very same people who earlier criticised the RBI for letting things drift and banks being allowed too much of forbearance. In sum, the larger fallout of the exercise is that there is a 'better credit discipline in the country'.

Unsolicited Advices

11. You must have experienced how many advices come your way if you suffer from an ailment. Every other person has an opinion and a remedy for the same, including weird alternate therapies. Situation here is not much different. Even as the RBI has launched steps to cleanse the banking system of its ill-health, everyone seems to have become wiser about the issue and have a prescription to offer. Some blame the patient, some blame the doctor and still others are blaming the procedure. So called expert opinions are being voiced about the credit appraisal process of banks, collateral availability, personal guarantee, restructuring, staff accountability and so on. If all these prescriptions are

followed, the outcome would be akin to a successful operation, but a dead patient. In other words, the lending process would freeze.

Post-Operative Care

12. All post-operative cases require rehabilitation and so would the banking system. There is a need for the system to pause and reflect on what has gone wrong. The form of life style change for the banks would be to concentrate on credit risks that they understand and which fall well within their risk appetite. Going forward, they have to refrain from binging on what their neighbours are eating. More simply put, the Board and the Top Management have to steer the bank in a manner that they have a robust credit appraisal process, effective post-disbursement supervision system, a diversified portfolio and better risk governance. The lifestyle changes for the borrowers on the other hand would entail adoption of a regimen more attuned to a marathon runner than a sprinter. Running enterprises is not a one-off sprint. Like a marathoner, one has to be conscious of the external environment at all times and run at a steady pace without exhausting himself.

Remedial Measures

13. Even post AQR, challenges abound. What are the possible solutions? That a vast majority of the corporates are overleveraged with severely diminished debt servicing ability is common knowledge. There are projects which need fresh capital, new management and new promoters. Banks are wary of increasing their commitments to accounts which are in stress, for a variety of reasons. It may be extremely difficult to operate the enterprise profitably without paring down debt levels and hence, a first step could possibly be to bring down the debt to a manageable level. This might involve writing down a part of the debt by the lenders and/or converting them into equity and bring in a new promoter to run the enterprise. This might, however, be a time consuming process and hence, in the interim the banks may need to appoint an O & M agent to run the operations.

14. In certain cases, there may be a need for additional funding for some residual investment or for working capital needs. A major impediment observed in JLF functioning is slow evolution of consensus among the consortium members and hence, the resultant action plan gets delayed invariably. The delay somehow defeats the very purpose for which the JLF mechanism is set up. There are some views about setting up an investment fund which might come in as a last mile lender. The investment fund could lend to the truncated enterprise and help it get back to profitability at which level banks could profitably dilute their equity holdings in the firm. Question is who would fund this investment fund? My sense is it would have to be joint endeavor of multiple players in this arena. Moreover, extending financial support would not be sufficient. Such fund would also need to have capability to provide management bandwidth to the concerned projects.

Conclusion

15. Let me conclude by saying that the global economy has been passing through a difficult phase and vulnerabilities remain. Against this backdrop and that in a globally integrated economy, a general decline in the asset quality was not totally unexpected. However, the extent being witnessed could have been avoided. It is probably because neither the banks nor the corporates resorted to preventive healthcare. I am sure that everyone would emerge much wiser after enduring the pain and be circumspect in the approach and get a periodic checkup done so that they can stay healthy and live longer.

16. For the enterprises under temporary duress, we must stretch every sinew to ensure that a productive enterprise does not become terminally ill. There are suppliers sometimes in the form of small ancillary units or MSMEs and then, there are workers and their families. Each enterprise supports many lives. There is an entire ecosystem around a factory or company. Closure of any running unit would impact the lives of scores of people and hence, I feel it's a collective societal responsibility that productive enterprises don't run aground.

I thank Edelweiss Management for inviting me to this Credit Conclave today and wish the deliberations all success.

Thank you!