Restraining Wilful Defaults: Need of the hour for Indian Banking system

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Foreword | Mr. Anil Khaitan, President, PHD Chamber

A strong banking system is crucial for the growth and development of an economy. Non-Performing Assets (NPAs) is an important prudential indicator to assess the financial health of the banking sector. Besides asset quality, NPAs epitomize the credit risk management and efficacy in the allocation of resources.

A high level of NPAs indicates a high incidence of credit defaults and affects the profitability and net-worth of banks and also erodes the value of the asset. Thus, it becomes very important to control the rising level of NPAs which is resulting in deteriorating of quality of banks' assets, posing high level of stress on banks' balance sheet and decaying overall profitability and efficiency of Indian banking system. The growth in Indian Banking sector is going to emerge to the full extent provided that the clean-up of bank balance sheet is undertaken effectively.

In India, the banks have witnessed a surge in their Gross Non Performing Assets (GNPAs) post the global financial crisis consequent to the collapse of Lehman Brothers in 2008. Since, India needs much healthier banks to strengthen and support higher economic growth, further deterioration in NPAs level in banks should be checked urgently.

In the present scenario of rising wilful defaults has become one of the major causes of inflating NPAs in Indian banks. This is observed that willful defaults have been rising in parallel to rising NPAs in India during the post financial crisis and has become a major cause of concern for Indian banks.

Few suggestions to mitigate the impact of wilful defaults includes careful monitoring of corporate activities after debt is sanctioned, effectively and efficiently tracking undisclosed assets, monitoring the progress of loans, improving credit sanctioning processes of banks, effective resolution plans, training of banking professionals, among others going forward.

Foreword | Rohit Karnatak, Managing Director | India, APAC & EMEA – Global Screening, Pinkerton

This white paper is an attempt to bring to attention the growing threat of NPAs and their impact on curbing the growth of the Indian banking sector. The large number of NPAs has had a considerable impact on the profitability of banks & their accumulation has adversely effected the bank's balance sheet, consequently resulting in a credit slowdown.

Value wilful default suits, have increased more than 9 times from around Rs. 10,299 Crores (2292 Million USD) in FY2005 to Rs. 99,954 Crores (14902 Million USD) in FY2017. In order to reduce the risk posed from wilful default, it is suggested that a systematic assessment and quantification of credit risk must be conducted. It is imperative to move towards a proactive approach for improving the credit sanctioning processes undertaken by banks, in order to sufficiently tackle the issue of stressed assets. This should include thorough background verification of individuals & organizations before allocation of funds, thorough due diligence, including physical verification of operations & collateral, meaningful scrutiny of quarterly progress reports prior to loan disbursal and monitoring of activities after the loan is sanctioned. This should be backed up by internal trainings of banking officials in order to develop the necessary expertise and internal capability to valuate projects and their feasibility.

Actively engaging with the chartered accountant community, and learning from best practices adopted globally towards risk & compliance policies, can add fresh direction & perspective to help bridge the gaps currently being faced by the Indian banking sector.

By failing to prepare one is preparing to fail. Identification and implementation of a holistic internal risk reduction strategy by each bank would be the first step to address this growing threat.

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Abbreviations

Abbreviation	Word/Phrase
AIFIs	All India Financial Institutions
CIBIL	Credit Information Bureau (India) Limited
CRAR	Capital to Risk Weighted Assets Ratio
CRILC	Central Repository of Information on Large Credits
DRT	Debt Recovery Tribunal
FBs	Foreign banks
GNPAs	Gross Non Performing Assets
MTM	Mark-to-market
NBFCs	Non-Banking Financial Companies
NPA	Non-Performing Assets
NNPAs	Net non-performing advances
PVBs	Private sector banks
RBI	Reserve Bank of India
RoA	Return on Asset
RoE	Return on Equity
SDR	Strategic Debt Restructuring
SMA	Special Mention Accounts
SCBs	Scheduled commercial banks

CHAPTER 1 | INTRODUCTION

Abstract

Across the globe, the growth of banking sector acts as the catalyst for the economic progress of any country. Banks play a vital role in providing financial resources especially to capital-intensive sectors such as infrastructure, automobiles, iron and steel, among others. In emerging economies, banks are more than mere agents of financial intermediation and carry the additional responsibility of achieving the government's social agenda. Owing to this close relationship between banking and economic development, the growth of the overall economy is intrinsically correlated to the health of the banking industry.

Several parameters like Net Profit, Return on Equity(RoE), Return on Asset (RoA) Capital to Risk Weighted Assets Ratio (CRAR), Credit-Deposit ratio etc. are measured for assessing the overall performance of the banks in terms of banks' profitability, capital adequacy and financial inclusion.

Non-Performing Assets (NPAs) are an important prudential indicator to assess the financial health of the banking sector. Besides asset quality, NPAs epitomize the credit risk management and efficacy in the allocation of resources.

Against this backdrop, this study pertains to undertake a comprehensive analysis of the present scenario of NPAs and wilful defaults in the country. The analysis also encompasses the implications of wilful defaults on various segments and makes an attempt to suggest concrete measures to curb the growth of non-performing assets in the coming times.

1.1 2008 crisis & Burgeoning NPAs

In India, the banks have witnessed a surge in their Gross Non Performing Assets (GNPAs) post the global financial crisis consequent to the collapse of Lehman Brothers in 2008. A surge in bad loans is majorly attributed to sluggish domestic as well as global economic growth, which in turn discourages companies to invest in new projects and to repay their loans and interest to the banks. Post 2008, the gross advances and gross NPAs have increased significantly.

Gross advances have increased from Rs. 2503431 crore (USD 621805 million[1]) in FY2008 to Rs. 8476705 crore (USD 1263822 million) in FY2017. Similarly, gross NPAs have also increased from Rs. 56606 crore (USD 14060 million) in FY2008 to Rs. 790268 crore (USD 117824 million) in FY2017.

Several factors, such as increased financial deepening, increased competition, improvement in asset quality of banks and rapid product innovations contributed to rapid credit expansion in the post crisis period. Infrastructure, SMEs, farm credit and retail sectors

[1] INR/USD Exchange rate for FY2008 stands at 40.26 and for FY2017 is 67.07

primarily powered the growth of bank credit during this period.

This widening divergence in the growth of credit and NPAs, result in the pulling out of funds by foreign investors and sluggish industrial growth, which in turn has painted an adverse picture of the asset quality of Indian banks However, the post financial crisis period i.e. fiscal years 2009 to 2016, witnessed a reversal in the earlier trends with significant growth in NPAs and gradual decline in gross advances.

Gross NPA ratio to total advances rose from 2.3 per cent in FY2009 to 9.3 per cent in FY2017. In absolute terms gross NPAs rose from Rs. 56,000 crores (USD 14060 million) in FY2008 to Rs. 790268 crores (USD 117824 million) in FY2017. However, growth in gross advances registered a steep decline from 25 per cent in FY2008 to around 4 per cent in FY2017.

1.2 NPAs: Global Comparison

At the international level, Indian banks suffered relatively less from the turmoil of the global financial crisis. However, their NPAs are still high amongst the BRICS economies barring Russia which is disappointing. According to the World Bank, NPAs to total gross loans of Indian banks stood at 9.2 per cent in 2016.

In contrast, the emerging market and developing economies viz. Thailand, Brazil, China and South Africa recorded NPA to total gross loans at 3.0 per cent, 3.9 per cent, 1.7 per cent and 2.9 per cent, respectively during the same period. Furthermore, the NPAs to total gross loans ratio in India has been increasing significantly since the year 2010.

A startling trend in comparison to countries like China, Japan, United States, South Africa, Thailand and UAE wherein the same metric has remained steady or declined.

On comparing with advanced regions/ countries India's position reflects a better picture. NPAs to total loan ratio in the Euro area has risen from 1.8 per cent in 2007 to 4.1 per cent in 2016, majorly attributed to the Euro Zone crisis. Russia also registered an increase in NPAs to total loans from 2.5 per cent in 2007 to 9.4 per cent during the same period. United States and Japan both registered a steady ratio of 1.3 per cent in 2016.

Table – 1.1 Cross-country comparison of NPAs to Total gross Loans (per cent) of select regions and economies

Country / Region	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Brazil	3	3.1	4.2	3.1	3.5	3.4	2.9	2.9	3.3	3.9
China	6.2	2.4	1.6	1.1	1	1	1	1.2	1.7	1.7
Euro Area	1.8	2.8	5.2	5.6	6.9	8.1	7.9	6.8	4.9	4.1
Indonesia	4	3.2	3.3	2.5	2.1	1.8	1.7	2.1	2.4	2.9
India	2.7	2.4	2.2	2.4	2.7	3.4	4.0	4.3	5.9	9.2
Japan	1.5	2.4	2.4	2.5	2.4	2.4	2.1	1.7	1.5	1.4
Russia	2.5	3.8	9.5	8.2	6.6	6	6	6.7	8.3	9.4
United States	1.4	3	5	4.4	3.8	3.3	2.5	1.9	1.5	1.3
South Africa	1.4	3.9	5.9	5.8	4.7	4	3.6	3.2	3.1	2.9
Thailand	7.6	5.6	5.2	3.9	2.9	2.4	2.3	2.3	2.7	3.0
United Arab Emirates	2.9	2.3	4.2	5.3	6.1	7.1	6.7	5.6	5.2	5.3
Hong Kong	0.8	1.23	1.58	0.83	0.69	0.6	0.54	0.51	0.73	0.9

Source: PHD Research Bureau, compiled from World Bank, Note: NPAs are also referred to as non-performing loans.

1.3 Recent Performance of Indian Banks – A Snapshot

As per the Financial Stability Report December 2017 by RBI, India's financial system remains stable and the stress in the banking sector, particularly the Public Sector Banks (PSBs), while significant, appear to be bottoming out. The risks to the banking sector remain at an elevated level weighed down by further asset quality deterioration as per Banking Stability Indicator (BSI).

The credit growth of scheduled commercial banks (SCBs) showed an improvement between March and September 2017, while Public Sector Banks (PSBs) continued to lag behind their private sector peers. The Gross Non-Performing Advances (GNPA) ratio of SCBs has increased from 9.6 per cent to 10.2 per cent between March and September 2017.

The GNPAs grew by 18.5 per cent on a year-on-year basis in September 2017. Private Sector Banks (PVBs) registered a higher increase in GNPAs of 40.8 per cent as compared to their public sector counterparts (17.0 per cent). The performance of Scheduled Commercial Banks (SCBs) is discussed below:

First, SCBs' credit growth on a y-o-y basis, increased from 4.4 per cent to 6.2 per cent between March and September 2017.

Second, credit growth of the Public Sector Banks' (PSBs) increased from 0.7 per cent to 2.2 per cent during the same period reversing the declining trend observed during past two years. On the other hand, deposit growth of SCBs, on a y-o-y basis, decelerated from 11.1 per cent to 7.8 per cent between March and September 2017.

Third, Capital to risk-weighted asset ratio (CRAR) of SCBs increased from 13.6 per cent to 13.9 per cent between March and September 2017 largely due to an improvement for private sector banks (PVBs).

Fourth, the Gross Non-Performing Advances (GNPA) ratio[2] of SCBs increased from 9.6 per cent to 10.2 per cent between March and September 2017, whereas, their Restructured Standard Advances (RSA) ratio declined from 2.5 per cent to 2.0 per cent. The Stressed Advances (SA) ratio[3] rose marginally from 12.1 per cent to 12.2 per cent during the same period.

Fifth, the Net Non-Performing Advances (NNPA) as a percentage of total net advances increased from 5.5 per cent to 5.7 per cent between March and September 2017. PSBs recorded distinctly higher NNPA ratio of 7.9 per cent

Sixth, the GNPAs of all SCBs increased by 18.5 per cent on a y-o-y basis in September 2017. PVBs registered a higher increase in GNPAs (40.8 per cent) as compared to their public sector counterparts.

Seventh, the asset quality of SCBs deteriorated across broad sectors between March and September 2017 with the industrial sector leading in this segment. It has been observed that among the major industry sub-sectors, mining and quarrying, food processing, engineering, construction and infrastructure registered increase in their stressed advances ratios between March and September 2017. The asset quality of sub-sectors such as textiles, rubber, cement, basic metals and vehicles, however, improved during the same period.

Eighth, the share of large borrowers[4] both in total SCBs' loans as well as GNPAs declined between March and September 2017. The total stressed advances of large borrowers increased by 2.4 per cent between March and September 2017. The GNPA ratio of large borrowers increased from 14.6 per cent to 15.5 per cent between March and September 2017. The GNPA ratios went up for both PSBs and PVBs, whereas, the same came down for foreign banks (FBs)

Table 1.2 Share of large borrowers in SCBs' loan portfolio

	Mar '15	Mar '16	Sep '16	Mar '17	Sep '17
Gross advances	58.1	58	56.5	56.0	55.7
Gross NPAs	72.8	86.4	88.4	86.5	83.4

Source: PHD Research Bureau, compiled from RBI

As per the RBI report, the aggregated balance sheet size of the NBFC sector stands at INR 13.8 trillion in September 2017 expanding by 15.6 per cent, as compared to INR 11.9 trillion in September 2016. GNPAs of the NBFC sector as a percentage of total advances increased from 4.4 per cent in March 2017 to 4.9 per cent in September 2017. NNPAs as a percentage of net advances also increased from 2.2 per cent to 2.4 per cent between March and September 2017

Table 1.3 Balance Sheet of NBFCs (Y-O-Y growth percent)

	Mar - 17	Sep - 17
Share capital	15.2	8.8
Reserves and surplus	12.2	18.1
Total borrowings	15.0	15.1

2 GNPA, RSA and SA ratios have been calculated as a percentage of total gross advances by RBI in its Financial Stability Report December 2017
3 RBI in its Financial Stability Report December 2017 stated that for the purpose of analysing the asset quality, stressed advances are defined as GNPAs plus RSAs.
4 A large borrower is defined as a borrower that has aggregate fund-based and non-fund based exposure of `50 million and more for the SCBs

	Mar - 17	Sep - 17
Current liabilities and provisions	16.0	26.7
Total liabilities/ assets	14.5	15.6
Loans & advances	16.4	15.7
Investments	11.9	15.8
Other assets	7.9	15.2
Income/expenditure		
Total income	8.9	15.3
Total expenditure	9.6	18.1
Net profit	(-) 2.9	4.7

Source: RBI

NPAs across all categories such as nationalized banks, SBI and its associates, private sector banks and foreign banks have increased. The large amount of NPAs has had a considerable impact on the profitability of these banks. The accumulation of NPAs has affected bank balance sheets adversely and a consequent credit slowdown.

There are various reasons to which the high amount of NPAs in the public sector can be attributed such as:

1. Exposure to infrastructure projects which had to be developed under PPP model.
2. Priority sector lending: Public Sector Banks have the responsibility to provide credit in order to fulfill the social objectives of government policy.
3. Risk measurement: Public sector banks although adopts policies for borrower screening, credit appraisals and post disbursement monitoring of the loan, however the effectiveness of policies and its implementation needs urgent attention.

In order to combat the problem of rising NPAs in the economy, the Government and the Central Bank have taken various steps, outlined in the next section.

1.4 Key Policy Developments in India

a.) The government has announced **Indradhanush plan** for revamping Public Sector Banks (PSBs) in August 2015. The plan envisaged, inter alia, infusion of capital in PSBs by the Government to the tune of Rs. 70,000 crore (USD 11449 million[5]) over a period of four financial years.

b.) **The Government has taken a massive step to capitalise PSBs** in a front-loaded manner, with a view to support credit growth and job creation. This entails mobilization of capital, with maximum allocation in the current year, to the tune of about Rs. 2,11,000 crore (USD 32754 million) over the next two years, through budgetary provisions of Rs. 18,139 crore (USD 2817 million), recapitalisation bonds to the tune of Rs. 1,35,000 crore (USD 20956 million), and the balance through raising of capital by banks from the market while diluting government equity, estimated potential Rs. 58,000 crore (USD 9003 million). The Government of India on 24th January 2018 unveiled details of the re-capitalisation of Public Sector Banks (PSBs) announced in October, 2017. The capital infusion plan for 2017-18 includes Rs.80,000 crore (USD 12418 million) through Recap Bonds and Rs. 8,139 crore (USD 1263 million) as budgetary support. This plan addresses regulatory capital requirement of all PSBs and provides a significant amount towards growth capital for increasing lending to the economy.

c.) **Financial Resolution and Deposit Insurance Bill, 2017:** The Financial Resolution and Deposit Insurance Bill, 2017 (FRDI Bill) will replace the existing resolution regime by providing a comprehensive resolution regime that will help ensure that, in the rare event of failure of a financial service provider, there is a system of quick, orderly and efficient resolution . The FRDI Bill proposes to establish a Resolution Corporation and a comprehensive resolution regime to enable timely and orderly resolution of a failing financial firm.

Table 1.4 Banks wise Gross NPAs (In Rs. Crore)

Category	Mar - 12	Mar - 13	Mar - 14	Mar - 15	Mar - 16	Mar - 17
State Bank of India and its associates	45694	62778	79816	73508	121969	177811
Nationalised banks	66795	101683	147447	204960	417988	506922
Private sector banks	18210	20382	24184	33690	55853	919146
Foreign Banks	6269	7926	11568	10758	15798	13621
Total (All Schedule Commercial Banks)	136968	192769	263015	322916	611607	790268

Source: PHD Research Bureau, compiled from RBI

5 Average exchange rate of Indian Rupee/USD stands at 61.14 in 2014-15

d.) Legal amendments to the **Debt Recovery Tribunal (DRT) Act (1993) and the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002** have been passed by the Government.

e.) The new **Insolvency and Bankruptcy Code (2016)** is intended to promote entrepreneurship, availability of credit, and balance the interests of all stakeholders by consolidating and amending the laws relating to reorganization and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner and for maximization of value of assets of such persons and matters connected therewith or incidental thereto.

f.) Besides Government's initiatives, the RBI released the **Framework for Revitalising Distressed Assets in the Economy** in January 2014. It 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. It also addresses the issue of information asymmetry and encourages early identification of the problem by setting up a Central Repository of Information on Large Credits (CRILC) to collect, store, and disseminate credit data to lenders. Under this arrangement, banks are now reporting credit information, including classification of an account as Special Mention Accounts (SMA) to CRILC on all their borrowers who are having an aggregate fund-based and non-fund based exposure of Rs. 50 million (USD 0.8 million[6]) and above.

g.) The RBI has also issued guidelines on **flexible structuring of long term project loans.** Infrastructure and core industries projects are characterised by long gestation periods and large capital investments. The long maturities of such project loans consist of the initial construction period and the economic life of the asset / underlying concession period (usually 25-30 years). In order to ensure stress free repayment of such long gestation loans, their repayment tenor should bear some correspondence to the period when cash flows are generated by the asset.

h.) The Reserve Bank of India has issued guidelines on a **'Scheme for Sustainable Structuring of Stressed Assets'**. This is in order to strengthen lender's ability to deal with stressed assets, and put real assets back on track by providing an avenue to rework the financial structure of entities facing genuine difficulties.

Resolution of large borrowal accounts which are facing severe financial difficulties may, inter-alia, require co-ordinated deep financial restructuring which often involves a substantial write-down of debt and/or making large provisions.

The Strategic Debt Restructuring (SDR) mechanism provides 18 months for banks to make prescribed provisions for the residual debt and Mark-To-Market (MTM) provisions on their equity holding arising from conversion of debt. Banks have requested for allowing more time to write down the debt and make the required provisions in cases of resolution of large accounts.

i.) The Financial Stability and Development Council Sub-Committee (FSDC-SC) held its 18th meeting on August 29, 2016. In this meeting, the report of the Financial Stability Board (FSB), Peer Review of India, report of the Working Group (WG) on Development of Corporate Bond Market in India, proposed a Bill on setting up of a statutory Financial Data Management Centre (FDMC), the Minimum Assured Return Scheme (MARS) under National Pension System (NPS) and regulation of spot exchanges were discussed.

j.) Effective and capable human resources in regulated entities are important for implementing and fulfilling regulatory objectives. In July 2014, the Reserve Bank had constituted a Committee on Capacity Building with the objective of implementing non-legislative recommendations made by the Financial Sector Legislative Reforms Commission (FSLRC).

These recommendations were related to capacity building in banks and non-banks, streamlining training interventions, and suggesting changes in view of ever increasing challenges in the banking and non-banking sectors. In August 2016, the Reserve Bank issued guidelines on capacity building in banks and AIFIs prescribing adoption of some of the recommendations of the committee.

k.) The Ministry of Corporate Affairs (MCA), Government of India had notified the Companies (Indian Accounting Standards) Rules, 2015 in February 2015. In January 2016, MCA outlined the roadmap for implementing the International Financial Reporting Standards (IFRS) converged Indian Accounting Standards (Ind AS) for banks, non-banking financial companies, select all-India term lending and refinancing institutions and insurance entities.

6 Average exchange rate of Indian Rupee/USD stands at 60.5 in FY 2014

Table – 1.5 Willful default suit value of Rs. 25 lakhs and above to Gross NPAs

Year	Gross NPAs (in Rs. crores)	Gross NPAs (USD million)	Value of willful default suit (in Rs. Crores)	Value of willful default suit (USD million)	Wilful default value to gross NPAs (in per cent)
FY2005	57396	12774	10299	2292	17.9
FY2006	51753	11689	8742	1975	16.9
FY2007	50517	11164	8453	1868	16.7
FY2008	56606	14060	10904	2708	19.3
FY2009	69954	15210	8725	1897	12.5
FY2010	81718	17224	13056	2752	16.0
FY2011	93997	20630	15275	3352	16.3
FY2012	136968	28581	23301	4862	17.0
FY2013	192769	35429	25410	4670	13.2
FY2014	263015	43472	39508	6530	15.0
FY2015	322916	52813	56799	9289	17.6
FY2016	611607	93420	79387	12126	13.0
FY2017	790268	117824	99954	14902	12.6

Source: PHD Research Bureau, compiled from RBI and CIBIL . Figures for USD have been calculated by using average exchange rate of the respective year Note 1: Gross NPAs data pertain to Scheduled Commercial Banks. Note 2: Value of willful default pertains to suit filed accounts (willful defaulters) of Rs. 25 lakhs and above. The figures are represented as round offs.

1.5 Wilful Defaults: Inflating NPAs

A strong banking system is crucial for the growth and development of an economy. NPA is a prudential indicator of the health of the banking system. A high level of NPAs indicates a high incidence of credit defaults and affects the profitability and net-worth of banks and also erodes the value of the asset. The NPA growth involves the necessity of provisions, which reduce the overall profits and shareholders' dividend.

Thus, it becomes very important to control the rising level of NPAs which is resulting in deteriorating of quality of banks' assets, posing high level of stress on banks' balance sheet and decaying overall profitability and efficiency of Indian banking system. The growth in Indian Banking sector is going to emerge to the full extent provided that the clean-up of bank balance sheet is undertaken effectively.

Since, India needs much healthier banks to strengthen and support higher economic growth, further deterioration in NPAs level in banks should be checked urgently.

There are several factors viz. industrial recession, sluggish economic growth, ineffective recovery system of banks, long legal procedures etc. that have been observed to be responsible for accumulation of NPAs in Indian Banks.

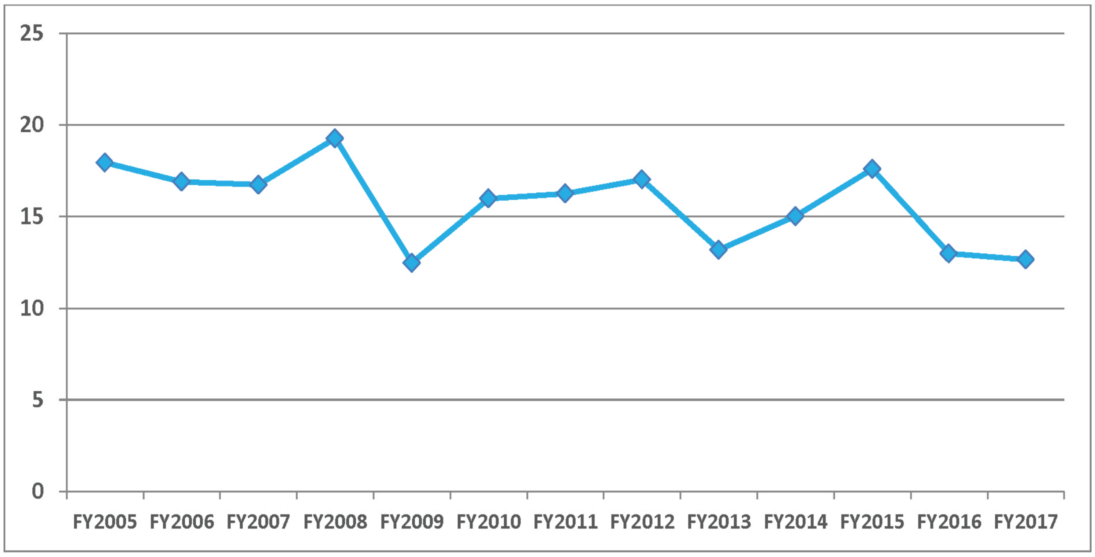
In the present scenario, wilful defaults are one of the major causes of increase in NPAs in Indian banks. During the post financial crisis, it has been observed that willful defaults have been rising in parallel to rising NPAs and have become a major cause of concern for Indian banks.

This is apparent from Table 1.5 that corresponding to the decline in gross NPAs before the outbreak of global financial crisis from Rs. 57 thousand crores (USD 12774 million) in FY2005 to Rs. 50 thousand crores (USD 11164 million) in FY2007, wilful defaults also witnessed a decline from the value of Rs. 10 thousand crores (USD 2292 million) in FY2005 to around Rs. 8 thousand crores (USD 1868 million) in FY2007. Thereafter, during the post financial crisis period both gross NPAs and willful defaults witnessed an increase to more than Rs. 7 lakh crores (USD 117824 million) and Rs. 99.9 thousand crores (USD 14902 million) respectively in FY2017.

The ratio of willful defaults to Gross NPAs was at around 18 per cent in FY2005 which declined to 12.6 per cent in FY2017 (Graph 1.1).

During the post global slowdown, the slow paced growth of the industrial sector and the economy coupled with global developments eroded the repaying capacity of the borrowers. This ultimately resulted in a steep surge in payment defaults, especially willful payment defaults. Therefore, in the present context, if the health of the banking system is to be improved it is crucial to tighten the regulatory noose on wilful defaulters.

Graph 1.1 Wilful default value to gross NPAs (in per cent)



Source: PHD Research Bureau, compiled from RBI and CIBIL

1.6 NPAs in MSMEs Sector

As envisaged by the Government's Make in India" initiative, easing access to finance for the MSMEs sector is critical for the creation of jobs, exports growth and development of a manufacturing base in India. The MSME sector forms the bedrock of Indian entrepreneurship, and must be nurtured appropriately to realise India's potential. The NPAs of micro and small enterprises stands at Rs 82500 crore (USD 12301 million) in FY2017 as against Rs 70800 crore (USD 10816 million) in FY2016.

Table – 1.6 Sector wise NPAs of Banks of Micro and Small Enterprises (in Rs. crore)

Bank Group	End March 2016	End March 2017
Public Sector Banks	65800 (USD 10052 million)	75700 (USD 11287 million)
Private Sector Banks	4700 (USD 718 million)	6400 (USD 954 million)
Foreign Banks	400 (USD 61 million)	400 (USD 60 million)
All Scheduled Commercial Banks	70800 (USD 10816 million)	82500 (USD 12301 million)

Source: PHD Research Bureau, compiled from RBI. Note: Note: Average exchange rate of INR/USD stands at 65.46for FY2016 and 67.07 for FY2017. NPAs of micro and small enterprises is of total priority sector

Table 1.7 Scheduled Commercial Banks (SCBs)

Year Ended	NPA Ratio in MSME (Priority Sector Only)	NPA Ratio in Large Industries
2002	18.25	13.63
2003	13.47	11.83
2004	11.30	9.03
2005	6.43	4.80
2006	5.94	2.81
2007	3.47	1.74
2008	2.52	1.14
2009	3.14	1.21
2010	3.36	1.51
2011	3.32	1.43
2012	3.22	1.94
2013	4.40	3.10
2014	4.71	4.80
2015	5.28	5.64
2016	8.77	11.75

Source: PHD Research Bureau compiled from Ministry of Finance, Government of India (PIB)

The details of Gross Non Performing Assets (GNPAs) ratio to MSMEs and large industries and corporate sector during last fifteen years are mentioned in Table 1.7. NPA Ratio of MSME (Priority Sector Only) has declined drastically from 18.25 per cent in 2002 to 8.77 per cent in 2016. The NPA Ratio of large industries and corporate sector has declined from 13.63 per cent to 11.75 per cent during the same period.

CHAPTER 2 | WILFUL DEFAULTERS CONCEPTUAL & REGULATORY FRAMEWORK

2.1 Wilful defaults: Conceptual & Regulatory Framework w.r.t RBI

Before undertaking a detailed analysis on wilful defaults it is pertinent to highlight its conceptual and regulatory framework in accordance with the recent amendments made by the Reserve Bank of India and its implications for different stakeholders including Banks, Auditors, Guarantors and Borrowers/Wilful defaulters.

2.1.1 Definitions

This is in accordance to the recent master circular on Willful Defaulters RBI/2015- 16/100DBR.No.CID. BC.22/20.16.003/2015-16 dated July 1, 2015 A 'willful default' would be deemed to have occurred if any of the following events is noted:

a.) The unit has defaulted in meeting its payment / repayment obligations to the lender even when it has the capacity to honour the said obligations.

b.) The unit has defaulted in meeting its payment / repayment obligations to the lender and has not utilised the finance from the lender for the specific purposes for which finance was availed of but has diverted the funds for other purposes.

c.) The unit has defaulted in meeting its payment / repayment obligations to the lender and has siphoned off the funds so that the funds have not been utilised for the specific purpose for which finance was availed of, nor are the funds available with the unit in the form of other assets.

d.) The unit has defaulted in meeting its payment / repayment obligations to the lender and has also disposed off or removed the movable fixed assets or immovable property given for the purpose of securing a term loan without the knowledge of the bank / lender.

The identification of the wilful default should be made keeping in view the track record of the borrowers and should not be decided on the basis of isolated transactions / incidents. The default to be categorised as wilful must be intentional, deliberate and calculated and information on wilful defaults should be collected in case of willful defaults of Rs. 25 lakhs (USD 0.038 million) and above.

The term '**unit**' appearing herein has to be taken to include individuals, juristic persons and all other forms of business enterprises, whether incorporated or not. In case of business enterprises (other than companies), banks/FIs may also report (in the Director column) the names of those persons who are in charge and responsible for the management of the affairs of the business enterprise.

The term '**lender**' covers all banks/FIs to which any amount is due, provided it is arising on account of any banking transaction, including off balance sheet transactions such as derivatives, guarantees and letter of credit.

2.1.2 Cut-off limits and Penal measures

This is keeping in view the present limit of Rs. 25 lakh (USD 0.038 million[7]) fixed by the Central Vigilance Commission for reporting of cases of wilful default by the banks / notified by All India Financial Institutions to RBI, any willful defaulter with an outstanding balance of Rs. 25 lakh (USD 0.038 million) or more, would attract the penal measures. The following penal measures are required to be initiated by the banks and FIs against the identified wilful defaulters:

i. No additional facilities should be granted by any bank / FI to the listed wilful defaulters.

ii. Such companies (including their entrepreneurs / promoters) where banks / FIs have identified siphoning / diversion of funds, misrepresentation, falsification of accounts and fraudulent transactions should be debarred from institutional finance from the scheduled commercial banks, Financial Institutions, NBFCs, for floating new ventures for a period of 5 years from the date of removal of their name from the list of wilful defaulters as published/disseminated by RBI/ Credit Information Companies (CICs).

iii. The legal process, wherever warranted, against the borrowers / guarantors and foreclosure for recovery of dues should be initiated expeditiously. The lenders may initiate criminal proceedings against wilful defaulters, wherever necessary.

iv. Wherever possible, the banks and FIs should adopt a proactive approach for a change of management of the wilfully defaulting borrower unit.

v. The borrowing company should not induct on its board a person whose name appears in the list of Wilful Defaulters.

2.1.3 End-Use of Funds

The banks/ FIs seek to ensure end use of funds by obtaining certification from the Chartered Accountants in cases of project financing. The banks and FIs, therefore, should not depend entirely on the certificates issued by the Chartered Accountants but strengthen their internal controls and the credit risk management system to enhance the quality of their loan portfolio. This may include thorough background verification of individuals/ organizations before allocation of funds, thorough due diligence including physical verification of operations & collateral, meaningful scrutiny of quarterly progress reports / operating statements.

7 Average exchange rate of INR/USD is 65.4 for FY2016

2.1.4 Role of Guarantors

When a default is made in making repayment by the principal debtor, the banker will be able to proceed against the guarantor / surety. Where a banker has made a claim on the guarantor on account of the default made by the principal debtor, the liability of the guarantor is immediate. In case the said guarantor refuses to comply with the demand made by the creditor / banker, despite having sufficient means to make payment of the dues, such guarantor would also be treated as a wilful defaulter. This treatment of non group corporate and individual guarantors was made applicable with effect from September 9, 2014.

2.1.5 Role of Auditors and Internal Audit

In case any falsification of accounts on the part of the borrowers is observed by the banks /FIs, and if it is observed that the auditors were negligent or deficient in conducting the audit, they should lodge a formal complaint against the auditors of the borrowers with the Institute of Chartered Accountants of India (ICAI) to enable the ICAI to examine and fix accountability of the auditors. The aspect of diversion of funds by the borrowers should be adequately looked into while conducting internal audit / inspection of their offices / branches and periodical reviews on cases of wilful defaults should be submitted to the Audit Committee of the bank.

2.1.6 Reporting to Credit Information Companies

Reserve Bank of India has granted Certificate of Registration to (i) Experian Credit Information Company of India Private Limited, (ii) Equifax Credit Information Services Private Limited, (iii) CRIF High Mark Credit Information Services Private Limited and (iv) Credit Information Bureau (India) Limited (CIBIL) to commence/carry on the business of credit information. Banks / FIs should submit the list of suit-filed accounts and non suit filed accounts of wilful defaulters of Rs. 25 lakh (USD 0.038 million) and above on a monthly or more frequent basis to all the four Credit Information Companies.

2.1.7 Mechanism for Identification of Wilful Defaulters

The transparent mechanism to identify the willful defaulter according to RBI's recent circular includes the following:

Evidence of wilful default on the part of the borrowing company and its promoter/whole-time director at the relevant time should be examined by a Committee headed by an Executive Director or equivalent and consisting of two other senior officers of the rank of GM / DGM.

↓

Call for their submissions and issue an order recording the fact of wilful default and the reasons for the same. An Opportunity for personal hearing to the borrower and the promoter / whole-time director can also be given to defaulter if the committee feels such an opportunity is necessary.

↓

Issuing of a Show Cause Notice to the concerned borrower and the promoter/whole-time director in case the Committee concludes that an event of wilful default has occurred.

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The Order of the Committee should be reviewed by another Committee and the Order shall become final only after it is confirmed by the said Review Committee.

Source: PHD Research Bureau compiled from RBI

KEY MEASURES FOR RESOLVING STRESSED ASSETS

The Gross Non-Performing Advances (GNPA) ratio of schedule commercial banks increased from 9.6 per cent to 10.2 per cent between March and September 2017. The stressed advances ratio marginally increased from 12.1 per cent to 12.2 per cent during the same period. Large borrowers i.e. borrowers with aggregate exposure of Rs. 5 crores and above account for 83.4 per cent. Several measures have been undertaken by the Government and RBI to strengthen the regulatory, legal, supervisory and institutional framework aiming at facilitating the quick resolution of stressed assets in a timely manner.

Strengthening the Legal Framework

The enactment of the Insolvency and Bankruptcy Code 2016 (IBC) is a step towards improving the credit culture in the country. Earlier, India had multiple laws govering various facets of a corporate rescue and /or insolvency process without having a comprehensive legal framework. The IBC provides a single window, time bound process for resolution of an asset with an explicit emphasis on promotion of entrepreneurship for maximisation of value of assets and balancing the interests of all stakeholders. An asset for a creditor in most cases is very valuable when it is generating adequate cash flow, as compared to an asset under liquidation.

IBC puts a time limit of 180 days (extendable by a further 90 days) within which creditors have to agree to a resolution plan, failing which the adjudicating authority under the law will pass a liquidation order on the insolvent company. Hence, threat of liquidation, which could potentially result in larger losses for creditors, will be an incentive for them to ensure efficient coordination during the insolvency resolution period, so as to quickly arrive at a decision. On the other hand, for the promoter the biggest cost of being pushed under IBC may be the possibility of losing the firm to potential bidders. This will incentivise the firms to avoid defaults or not to over borrow in first place and improve the credit culture in the country. Thereafter, the Banking Regulation (Amendment) Ordinance 2017 empowers the RBI to issue directions to banking companies to initiate an insolvency resolution process in respect of a default, under the provisions of the IBC. It also enables the Reserve Bank to issue directions with respect to stressed assets and specify one or more authorities or committees with such members as the Bank may appoint or approve for appointment to advise banking companies on resolution of stressed assets.

Evolving regulatory framework

Several steps have been undertaken by the RBI to strengthen the supervisory and regulatory framework to ensure timely recognition and disclosure of incipient stress and to facilitate effective and meaningful resolution. One of the significant steps from the perspective of aligning the regulatory norms with international practices is the decision to do away with the regulatory forbearance regarding asset classification on restricting of loans and advances effective April 2015.

The Asset Quality Review (AQR) is one of the critical steps undertaken in 2015-16 in recognizing the aggregate stock of non-performing assets across the banking system. Further, additional tools to deal with problem assets were also introduced, in the absence of an effective resolution framework. These tools primarily facilitate optimal structuring of credit facilities aids in ability to change in ownesrhip/management and help restructuring of stressed assets. A framework has been put in place for greater transparency in the sale of stressed assets by banks for ensuring sale at market determined prices. Further, disclosure requirements have been put in place so that banks disclose the divergence between the NPAs and provisions declared by them in their annual accounts and those assessed during the Annual Financial Inspections (AFIs) process. The recent decision by SEBI that requires listed entities to disclose defaults on, inter alia, bank loans within one working day can make a huge difference in the credit culture.

The system of 'Prompt Corrective Action' (PCA) under which specific regulatory actions are taken by RBI if banks breach certain trigger points has recently been revised. This ensures timely supervisory action in case of problem banks following a rule based approach. The PCA's objective and design is to strengthen a bank's fundamentals and imbue confidence.

Institutional measures

Setting up of the Central Repository of Information on Large Credits (CRILC) by RBI in 2014 filled a gap in addressing the information asymmetry regarding NPAs by facilitating collection of data on all borrowers' credit exposures across the banking system. This enables the supervisors or lenders to track the incipient stress by having the aggregate view of borrower and bank wise exposures in a particular account in a timely manner. In order to strengthen the role of the Overseeing Committee (OC), the RBI brought OC under its aegis with an expanded membership to review the process followed by banks for restructuring outside the IBC.

It reinforces the statute –backed authority of the OC to review the processes and provide requisite comfort to the lenders, particularly public sector banks, to agree to a market determined haircuts as part of restructuring. The Government and the RBI are in dialogue to prepare a package of measures to enable PSBs to shore up requisite capital in a time bound manner. The measures could include a combination of capital raised from the market, dilution of government holding, additional capital infusion by the Government, mergers based on strategic fit, sale of non-core assets, etc. Honorable Governor of RBI recently called for a higher recapitalisation of the public sector banks and stated that Public Sector Banks PSBs will need to take haircuts on current exposures under any resolution plan agreed within or outside the IBC.

Joint Lenders Forum (JLF) Mechanism: The Framework for Revitalising Distressed Assets in the Economy in January 2014, with the objective of addressing coordination problems in large, consortium accounts, envisaged constitution of the JLF.

Revised framework for resolution of Stressed Assets - In view of the enactment of the Insolvency and Bankruptcy Code, 2016 (IBC), it has been decided by RBI to substitute the existing guidelines with a harmonised and simplified generic framework for resolution of stressed assets.

Early identification and reporting of stress - Lenders shall identify incipient stress in loan accounts, immediately on default, by classifying stressed assets as special mention accounts (SMA) as per the following categories:

Special mention accounts (SMA) Sub-categories	Basis for classification – Principal or interest payment or any other amount wholly or partly overdue between
SMA-0	1-30 days
SMA-1	31-60 days
SMA-2	61-90 days

Source: Reserve Bank of India

According to the revised framework, lenders shall report credit information, including classification of an account as SMA to Central Repository of Information on Large Credits (CRILC) on all borrower entities having aggregate exposure of Rs. 50 million and above with them. The CRILC-Main Report will now be required to be submitted on a monthly basis effective April 1, 2018. In addition, the lenders shall report to CRILC, all borrower entities in default (with aggregate exposure of Rs. 50 million and above), on a weekly basis, at the close of business on every Friday, or the preceding working day if Friday happens to be a holiday. The first such weekly report shall be submitted for the week ending February 23, 2018.

Banking Regulation (Amendment) Ordinance, 2017

The Ordinance enables the Union Government to authorize the Reserve Bank of India (RBI) to direct banking companies to resolve specific stressed assets leading to effective resolution of stressed assets, particularly in consortium or multiple banking arrangements.

The promulgation of the Banking Regulation (Amendment) Ordinance, 2017 inserted two new Sections (viz. 35AA and 35AB) after Section 35A of the Banking Regulation Act, 1949 enables the Union Government to authorize the Reserve Bank of India (RBI) to direct banking companies to resolve specific stressed assets by initiating the insolvency resolution process, wherever required. The RBI has also been empowered to issue other directions for resolution, and appoint or approve for appointment, authorities or committees to advise banking companies for stressed asset resolution.

This will have a direct impact on effective resolution of stressed assets, particularly in consortium or multiple banking arrangements, as the RBI will be empowered to intervene in specific cases of resolution of non-performing assets, to bring them to a definite conclusion.

The Government is committed to expeditious resolution of stressed assets in the banking system. The recent enactment of the Insolvency and Bankruptcy Code (IBC), 2016 has opened up new possibilities for time bound resolution of stressed assets. The SARFAESI and Debt Recovery Acts have been amended to facilitate recoveries.

Union Cabinet gives in-principle approval for Public Sector Banks to amalgamate through an Alternative Mechanism (AM)

The Union Cabinet chaired by the Honorable Prime Minister Shri Narendra Modi has given in-principle approval for Public Sector Banks to amalgamate through an Alternative Mechanism (AM) on 23rd August 2017. The decision would facilitate consolidation among the Nationalised Banks to create strong and competitive banks. This decision will facilitate the creation of strong and competitive banks in the public sector space to meet the credit needs of a growing economy, absorb shocks and have the capacity to raise resources without depending unduly on the state exchequer.

The salient features of the Framework for Consolidation of Public Sector Banks are as follows:

1. The decision regarding creating strong and

competitive banks would be solely based on commercial considerations.

2. The proposal must start from the Boards of Banks.
3. The proposals received from Banks for in-principle approval to formulate schemes of amalgamation shall be placed before the Alternative Mechanism (AM).
4. After in-principle approval, the Banks will take steps in accordance with law and SEBI's requirements.

The final scheme will be notified by Central Government in consultation with the Reserve Bank of India.

Relief for MSME Borrowers registered under Goods and Services Tax (GST): Presently, banks and NBFCs in India generally classify a loan account as Non-Performing Asset (NPA) based on 90 day and 120 day delinquency norms, respectively. As a measure of support to these entities in their transition to a formalised business environment, RBI has decided that the exposure of banks and NBFCs to a borrower classified as micro, small and medium enterprise under the Micro, Small and Medium Enterprises Development (MSMED) Act, 2006, shall continue to be classified as a standard asset in the books of banks and NBFCs subject to the following conditions:

v. The borrower is registered under the GST regime as on January 31, 2018.
vi. The aggregate exposure, including non-fund based facilities, of banks and NBFCs, to the borrower does not exceed Rs. 250 million as on January 31, 2018.
vii. The borrower's account was standard as on August 31, 2017.
viii. The amount from the borrower overdue as on September 1, 2017 and payments from the borrower due between September 1, 2017 and January 31, 2018 are paid not later than 180 days from their respective original due dates.
ix. A provision of 5% shall be made by the banks/ NBFCs against the exposures not classified as NPA in terms of this circular. The provision in respect of the account may be reversed as and when no amount is overdue beyond the 90/120 day norm (Consequent upon transition to 90 day delinquency norm with effect from March 31, 2018 for NBFCs, provision reversal will be with reference to the 90 day norm), as the case may be.
x. The additional time is being provided for the purpose of asset classification only and not for income recognition, i.e., if the interest from the borrower is overdue for more than 90/120 days (Consequent upon transition to 90 day norm with effect from March 31, 2018 for NBFCs, restriction on income recognition on accrual basis will be with reference to interest overdue for more than 90 days), the same shall not be recognised on accrual basis.

IBC Mechanism being used actively to resolve NPA problem : According to Economic Survey 2017-18, IBC Mechanism being used actively to resolve NPA Problem. An ecosystem for the new insolvency and bankruptcy process took shape in 2017-18. A major factor behind the effectiveness of the new Code has been the adjudication by the Judiciary. The Code prescribes strict time limits for various procedures under it. In this process, a rich case-law has evolved, reducing future legal uncertainty.

CHAPTER 3 | MEASURING MAMMOTH OF WILFUL DEFAULTS

3.1 Measuring mammoth of wilful defaults

Wilful defaults pose a serious financial threat to the overall Indian banking system in terms of eroding its profitability and lending capacity. This may further lead the Indian industrial sector to become vulnerable and incapable of enhancing level of investments and production, thus impacting the entire economic system of the country.

In order to understand the gravity of the situation, a brief analysis pertaining to current state and trends of wilful defaults is conducted here below:

Table – 3.1 Suit-filed accounts (Wilful defaulters) of Rs. 25 lacs and above

Fiscal Year	Number of wilful default suit filed	Per cent change in willful defaults suit filed	Value of wilful default suit (in Rs. Crores)	Value of wilful default suit (USD million)	Per cent change in value of wilful default Suits
FY2002	1673	–	6175	1295	–
FY2003	2491	48.9	11298	2335	80.3
FY2004	2816	13.0	13871	3019	29.3
FY2005	2606	-7.5	10299	2292	-24.1
FY2006	2499	-4.1	8742	1975	-13.8
FY2007	2143	-14.2	8453	1868	-5.4
FY2008	2774	29.5	10904	2708	45.0
FY2009	2252	-18.9	8725	1897	-30.0
FY2010	3448	53.1	13056	2752	45.1
FY2011	4017	16.5	15275	3352	21.8
FY2012	4438	10.5	23301	4862	45.0
FY2013	3890	-12.3	25410	4670	-3.9
FY2014	5092	30.9	39508	6530	39.8
FY2015	5994	17.9	56799	9289	42.3
FY2016	7585	25.4	79387	12126	30.5
FY2017	8651	15.9	99954	14902	22.9

Source: PHD Research Bureau, compiled from RBI and CIBIL

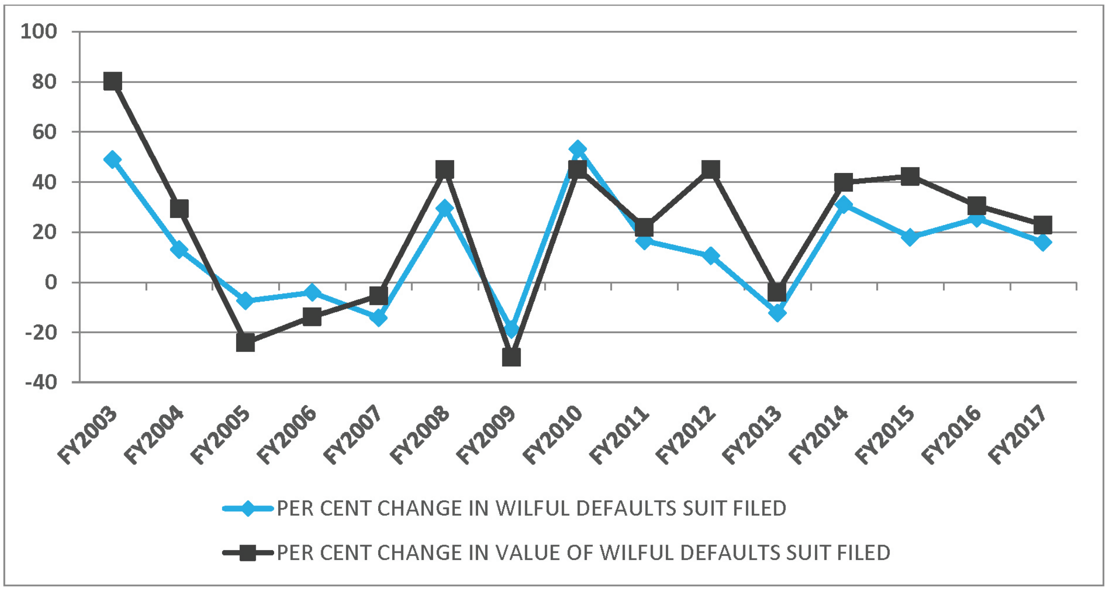
3.1.1 Wilful defaults – Number and Absolute Value of suits filed

Table 3.1 shows the number of suits filed against wilful defaulters as being more than 1670 in FY2002, which after rising by 49 per cent reached 2491 in FY2003. They eventually started declining and remained in negative growth trajectory during the three years preceding the global financial crisis. This indicates a decline in wilful defaulters corresponding to fall in NPAs in Indian banking system. However, FY2008 witnessed a steep rise in the number of wilful default suits to 2774 which can be attributed to the financial meltdown of the global economy.

Since then, barring a few years, the number of suits filed in the case of wilful defaulters have been steadily on the rise. During the period FY2008 - FY2017, the average growth in number of suits for wilful defaults have risen by around 17 per cent. In all, number of suits filed pertaining to wilful defaults rose to more than 5 times from 1673 in FY2002 to more than 8600 in FY2017.

In terms of absolute value, wilful defaults increased by more than 16 times from around Rs. 6,175 crores (USD 1295 million) in FY2002 to Rs. 99954 crores (USD 14902 million) in FY2017.

Figure – 3.1 Suit-filed accounts (Willful defaulters) of Rs. 25 lacs and above



Source : PHD Research Bureau, compiled from Credit Information Bureau (India) Limited

3.1.2 Wilful defaults – State Wise

State-wise analyses of wilful defaults suits shows that out of the total of 8651 suits, Maharashtra, as on 31st march, 2017 registered over 1600 number of wilful suits filed accounts; the highest amongst all States in the country (Figure -3.2) . On the other hand, West Bengal, Delhi, Andhra Pradesh and Tamil Nadu registered 1101, 831, 769 and 553 suits respectively at the same point of time.

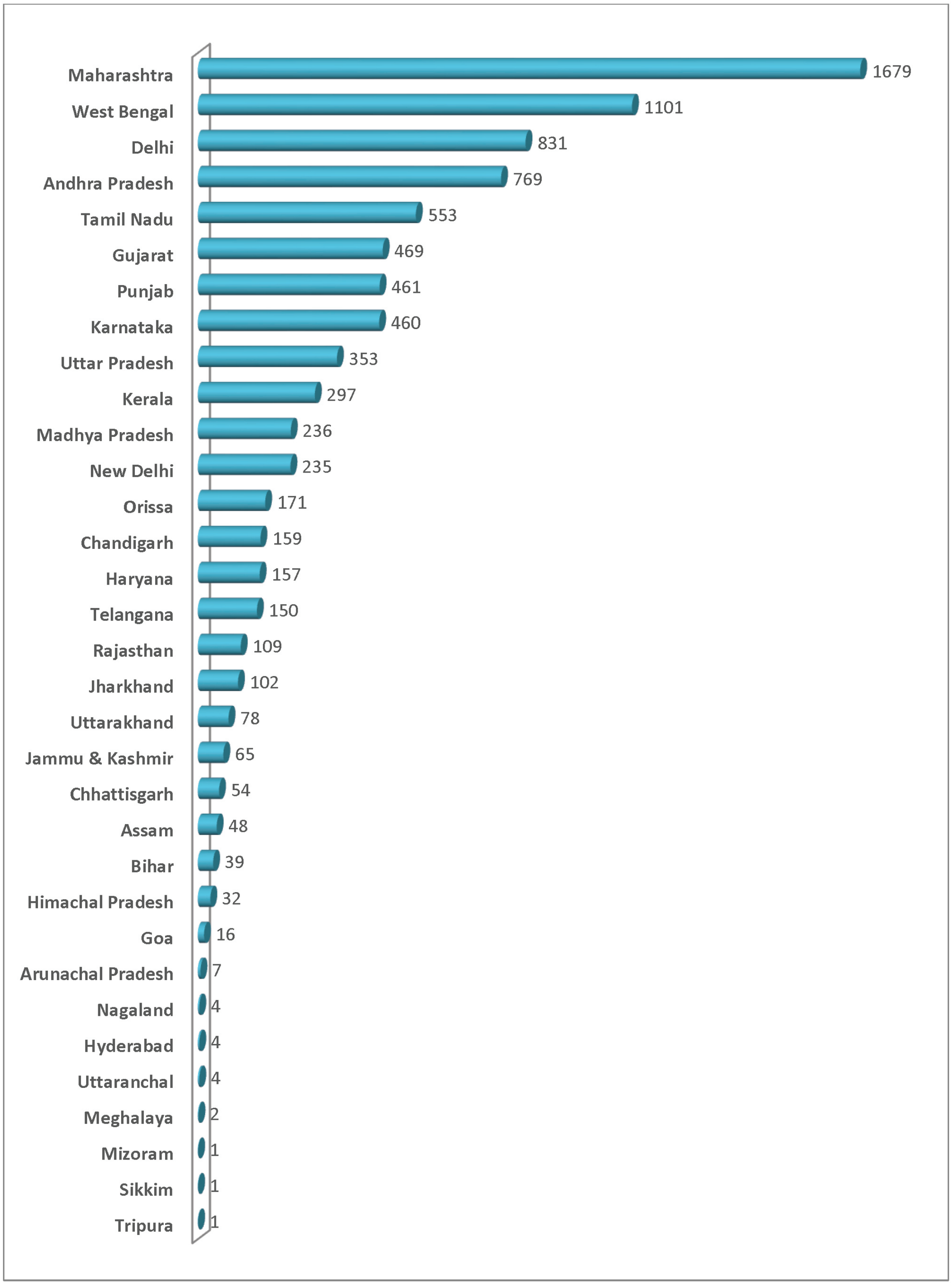
Few States viz. Gujarat, Punjab and Karnataka, registered more than 400 wilful suits, while Uttar Pradesh's wilful suits stands at 344 as on 31st March 2017. Kerala, New Delhi and Madhya Pradesh registered more than 200 numbers of willful suits. Orissa, Chandigarh, Haryana, Telangana, Rajasthan and Jharkhand have registered wilful suits less than 200. The rest of the States, registered less than 100 suits filed against wilful defaulters as on the same point of time.

In terms of value of suits[8] filed against wilful defaulters, Maharashtra, Delhi, West Bengal, Tamil Nadu and Gujarat are the top five States registering the highest value of wilful defaults in the country. Maharashtra with wilful defaults of Rs. 36 thousand crores (USD 5391 million) accounts for the highest value of suits filed against wilful defaults as on 31st March, 2017. This is followed by Delhi with wilful defaults of value Rs 11740 crores (USD 1750 million), West Bengal at Rs 9340 crores (USD 1393 million), Tamil Nadu with wilful defaults of value over Rs. 7 thousand crore (USD 1053 million[9]) and Gujarat having wilful defaults of value over Rs. 6 thousand crore (USD 988 million).

8 Data pertains to as on 16 March 2018

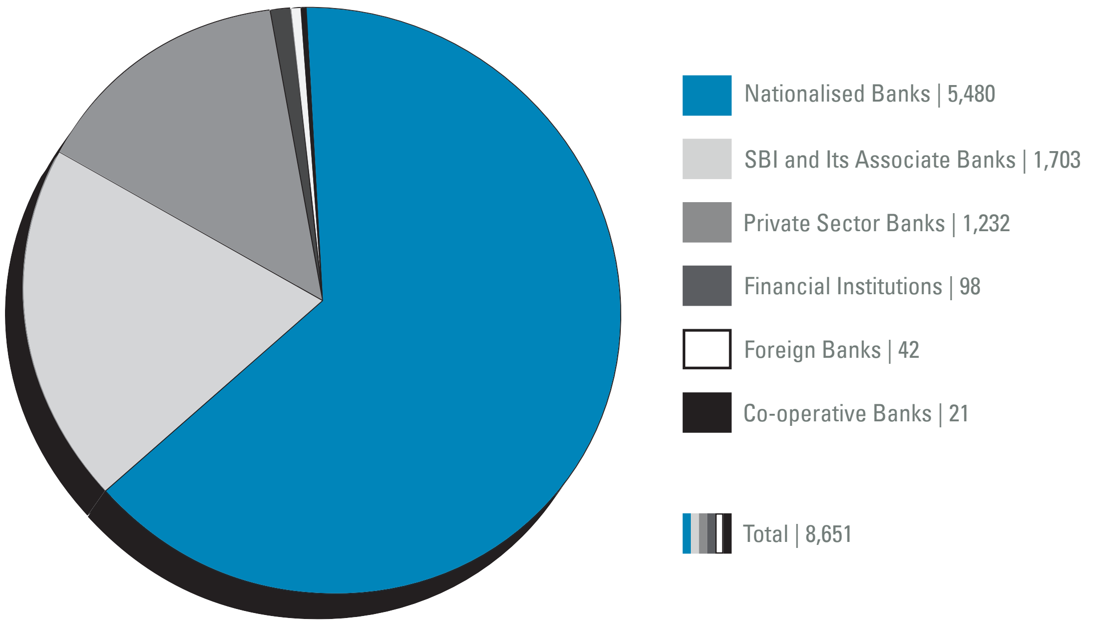
9 Average exchange rate of INR/USD for FY2017 stands at 67.07

Figure – 3.2 Number of Suits filed accounts (wilful defaulters) of Rs. 25 Lacs and above as on 31st March, 2017 by Geographic Distribution



Source : PHD Research Bureau, compiled from CIBIL. Note: Data pertains to as on 16 March 2018

Figure – 3.3 Suit-filed accounts (wilful defaulters) of Rs. 25 Lacs and above as on 31st March -2017 (Number)

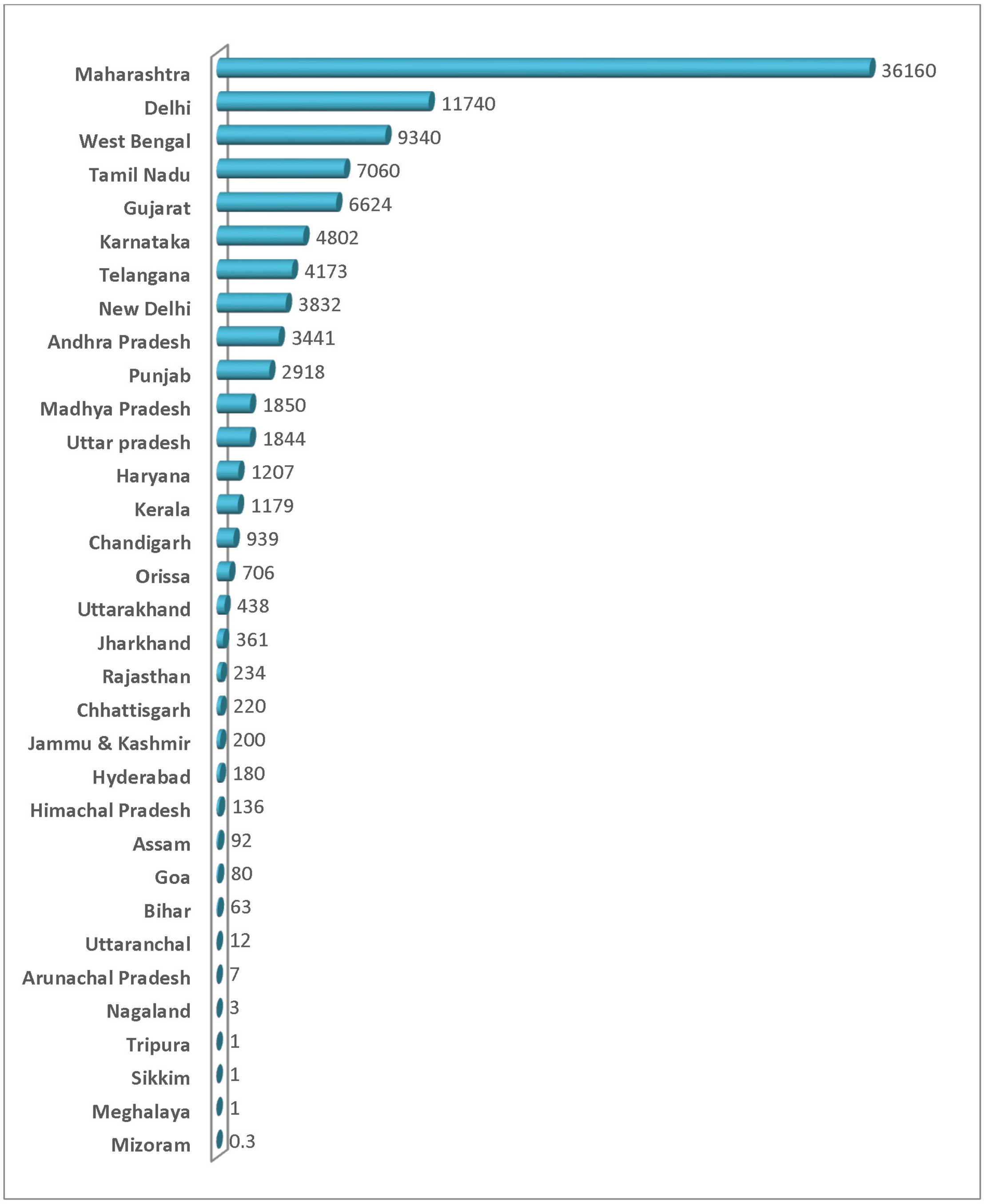


Source : PHD Research Bureau, compiled from CIBIL. Note: Data pertains to as on 16 March 2018. Data are represented as round offs. The total suits filed also include number of housing finance corporation (75).

3.1.3 Wilful defaults – Institution wise

Indian financial system which comprises of major financial institutions, foreign banks, nationalized banks, private sector banks, SBI and its associate banks, witnessed wide variations pertaining to the number of suits filed against wilful defaulters. This is apparent in figure- 3.3 where of the total suits filed against wilful defaults amounting to 8651 suits, nationalized banks registered the highest number of suits filed i.e. 5480 which constitutes around 64 per cent share in the total suits filed as on 31st March 2017. This is followed by the SBI and its associates which have registered more than 1700 cases and constitute for 20 per cent of the total wilful defaults suit filed at the same point of time. Meanwhile, private sector banks, financial institutions, foreign banks and co-operative banks combined together have filed 1393 suits and constitute for 16 per cent of the total suits filed at the same point of time.

Figure – 3.4 Value of Suits filed accounts -Wilful defaulters of Rs. 25 Lacs and above as on 31st March, 2017 (in Rs. Crore) by geographic distribution



Source: PHD Research Bureau, compiled from CIBIL

CHAPTER 4 | FACTORS CAUSING NPAS AND ITS IMPLICATIONS

A strong and vibrant banking sector is critical for a flourishing economy. The growth of NPAs can be attributed to multiple factors, including internal as well as external factors.

Internal factors include funds borrowed for a particular purpose but not used for the said purpose, non-completion of project in time, poor recovery of receivables, willful defaults, siphoning of funds, fraud, disputes, management disputes, diversion of funds, business failures, inability of the corporates to meet adequate capital requirements, etc.

On the other hand, external factors include natural calamities like floods, accidents, shortage of raw materials, recession in other countries, among others.

Higher NPA ratio trembles the confidence of investors, depositors and lenders. It also causes poor circulation of funds, which in turn have deleterious effects on the deployment of credit. The non-recovery of loans effects not only the availability of credit but also the financial soundness of the banks. As the NPA of the banks rise, the scarcity of funds in the Indian security markets rises, willingness of bank for loans diminishes and as a result shareholders of the banks will lose a lot of money as banks themselves will find it tough to survive in the market.

In such scenario, the price of loans, i.e. the interest rates will shoot up and will directly impact the investors who wish to apply loans for infrastructural or industrial projects. This ultimately impacts the retail consumers, who are forced to shell out higher interest rates for the loans.

Further, low release of funds from the security markets will hurt the overall demand in the Indian economy. In a nutshell, the high incidence of NPAs has a cascading effect on all important financial ratios of the banks viz., Net Interest Margin, Return on Assets, Profitability, Dividend Payout, Provision Coverage Ratio, Credit contraction etc. This may likely erode the value of all stakeholders including shareholders, depositors, borrowers, employees and the general public at large.

CHAPTER 5 | ASSET RESTRUCTURING COMPANIES

Keeping in view the greater role envisaged for Asset Reconstruction Companies (ARCs) and recent regulatory changes governing sale of stressed assets by banks to ARC, the RBI has decided to fix the minimum Net Owned Fund (NOF) requirement for ARCs at Rs. 100 crore (USD[10] 15.5 million) on an ongoing basis with effect from April 28, 2017. Further, no ARC shall commence or carry on the business of securitisation or asset reconstruction without having Net Owned Fund (NOF) of not less than Rs. 2 crores or such other higher amount as per the notification by RBI.

RBI as part of the framework for revitalising distressed assets in the economy had amended certain guidelines relating to sale of Non-Performing Assets (NPAs) by banks to Securitisation Companies (SCs) / Reconstruction Companies (RCs). In order to further strengthen the banks' ability to resolve their stressed assets effectively, it has been decided to put in place an improved framework governing sale of such assets by banks to SCs/RCs/other banks/NBFCs/Financial institutions etc.

Guidelines on sale of stressed assets by banks

In terms of extant instructions of the Reserve bank, the board of banks shall lay down detailed policies and guidelines on sale of their stressed assets to Securitisation Companies (SCs)/ Reconstruction Companies (RCs) which shall cover the following aspects:

- Financial assets to be sold
- Norms and procedures for sale of such financial assets
- A valuation procedure to be followed to ensure that a realistic value of financial assets is reasonably estimated.
- Delegation of powers of various functionaries for taking decision on the sale of the financial assets.

In order to enhance transparency in the entire process of sale of stressed assets, it has been decided by RBI as under:

- Identification of stressed assets beyond a specifies value, as may be determined by bank's policy for sale shall be top-down i.e., the head office/corporate office of the bank shall be actively involved in identification of stressed assets, including assets which are classified as Special Mention Account, to be put on sale. Early identification will help in low vintage and better price realization for banks.
- At least once in a year, preferably at the beginning of the year, banks shall, with the approval of their Board, identify and list internally the specific financial assets identified for sale to other institutions, including SCs/RCs
- At a minimum, all assets classified as 'doubtful asset' above a threshold amount should be reviewed by the board/board committee on periodic basis. The assets identified for exit shall be listed for the purpose of sale.
- Prospective buyers need not be restricted to SCs/ RCs. Banks may also offer the assets to other banks/NBFCs/FIs, etc. who have the necessary capital and expertise in resolving stressed assets. Participation of more buyers will result in better price discovery.
- In order to attract a wide variety of buyers, the invitation for bids should be preferably be publicly solicited so as to enable participation of as many prospective buyers as possible. In such cases, it would be desirable to use e-auction platforms.
- Banks must provide adequate time for due diligence by prospective buyers which may vary as per the size of the assets, with a floor of two weeks
- Banks should have clear policies with regard to valuation of assets proposed to be sold.
- The cost of valuation exercise shall be borne by the bank, to ensure that the bank's interests are protected.
- The discount rate used by banks in the valuation exercise shall be spelt out in the policy. This may be either the cost of equity or average cost of funds or the opportunity cost or some other relevant rate, subject to a floor of the contracted interest rate and penalty, if any.
- Banks shall review the efficacy of their extant polices on sale of NPAs with valuation of stressed assets and rework their polices.
- In order to make sure that sale of stressed assets by banks actually result in true sale of assets and to create a vibrant stressed assets market, it has been decided by RBI to progressively restrict banks' investment in Security Receipts (SRs) backed by their own stressed assets.

10 Average exchange rate INR/USD 64.3 2017-18 (till 25 Sep 2017)

CHAPTER 6 | SUGGESTIONS/RECOMMENDATIONS

- **Improving credit sanctioning processes of banks:** The assessment and quantification of credit risk by banks should follow scientific methods and must be priced accordingly. This process should include thorough background verification of individuals/ organizations before allocation of funds. The thorough due diligence should include physical verification of operations & collateral, meaningful scrutiny of quarterly progress reports / and operating statements. Risk must be controlled through Loan Review Mechanism and portfolio management. Besides proper credit risk management, banks must structure credit schemes as indicated appropriate by the analysis of company cash flows.
- **Monitoring corporate activity after debt is sanctioned:** Banks must keep track of business activities after it sanctions a loan in order to identify the probable defaulters and take corrective action in a timely manner.
- **Tracking undisclosed assets:** The bank must make a thorough assessment of the borrower's assets other than those pledged as collateral, as it will enable them to recover their loans in case of willful default.
- **Loan waiver schemes:** Loans to priority sector, specially farming, are often waived by the government, particularly state governments. The government should avoid mass waivers as it encourages willful defaults and leaves an impression that their loan repayment will be waived.
- The recent announcement made by the Government of India has given more powers to the RBI to curtail the menace of NPAs. This involves setting up of an Internal Advisory Committee (IAC) by RBI which comprises majorly of its independent Board Members, to advise it in regard to the cases that may be considered for resolution under the Insolvency and Bankruptcy Code, 2016 (IBC).

  The IAC also arrived at an objective, non-discretionary criterion for referring accounts for resolution under IBC. In particular, the IAC recommended for IBC reference all accounts with fund and non-fund based outstanding amount greater than Rs. 5000 crore, with 60 per cent or more classified as non-performing by banks as of March 31, 2016. The IAC noted that under the recommended criterion, 12 accounts totaling about 25 per cent of the current gross NPAs of the banking system would qualify for immediate reference under IBC.

  As regards the other non-performing accounts which do not qualify under the above criteria, the IAC recommended that banks should finalise a resolution plan within six months. In cases where a viable resolution plan is not agreed upon within six months, banks should be required to file for insolvency proceedings under the IBC. In this regard, banks should effectively finalize their resolution plans in order to overcome the negative impact of NPAs on their banking activities and the overall banking system.
- The RBI has issued guidelines that entail involvement of top management in actively managing the credit risk of the banks. Banks are required to put in place proactive credit risk management practices like annual/half-yearly industry studies and individual obligor reviews, credit audit which entails periodic credit calls that are documented, periodic visits of plant and business site, and at least quarterly management reviews of troubled exposures / weak credits.
- **Public Sector Banks:** Greater autonomy should be awarded to PSBs in terms of governance, Human Resource and operations. This would result in accountability while conserving the stability that comes with publicly owned enterprises. It would also enable PSBs to use new technology and processes. A few reforms driven by a global reform structure pertaining to capital, liquidity and disclosure standards under the Basel III package and other measures are Total Loss Absorbing Capacity (TLAC), Systemically Important Banks (SIBs), misconduct rules, etc.
- Public Sector Banks should appoint Relationship Managers for sets of Customers. Apart from managing the relationship between Bank and Corporate customer, the Relationship Manager should also be a “Whistle Blower”. He should blow the whistle as and when he finds that the concerned Corporate has delayed in Salary payment, in Provident Fund or any other Statutory Obligations. This is the first sign of sickness and action plan should be made immediately with the concerned Corporate to eradicate the problem at the very start. Corporates which require help at initial stage should be helped immediately, if it is a true and genuine case.
- Banks should concentrate on financial viability and liquidity of each of its customers and not only on Securities. Each Bank should get a Private Market Report, through its own contact, about the proposed Applicant and its Promoters. Banks should be proactive in sanctioning and disbursing their loans so that Corporates don't stop for finance which ultimately leads into NPAs.

- Promoters not following **proper financial management** practices should be held accountable. Middle level staff and clerical staff needs to be educated towards customer service, promptness and implementation of decisions. There should be a periodical visit of people from the Banks Head Office or Regional office to the various Corporates to assess the ground reality of the situation. Further, Crony Capitalism has to be stopped immediately.
- **Reducing dependence on restructuring loans:** Banks must reduce their dependence on restructuring loans. They should strengthen the process of identifying and recovering stressed assets as soon as possible. Banks should also diversify their customer base to reduce concentrated exposure, especially to sectors which are prone to NPAs.
- **Training of banking professionals:** It is imperative to create a skilled workforce so that banks can have necessary expertise and develop internal capabilities to evaluate projects and their feasibility. Further, there must be incentives and penalties for banking professionals in order to ensure accountability on their behalf.
- Consolidation of various banks is necessary as it will help in creating healthier banking system in the country. It may results into revenue enhancements, value maximization, efficiency gains, costs savings, diversification of customers and assets, ease to access banking activities and large banks will help in attaining international recognition, among others. However, it is necessary that the employment scenario is not impacted.
- Going ahead, increased automation would lead to reduction in cost and leave more room for increase in budgets for trainings and creating wings to oversee and monitor corporate activity after debt is sanctioned. Further, it will facilitate the borrowers to no longer go to multiple wings to get a loan sanctioned from a single bank entity.
- There is also a need to look into the role of Chartered Accountants' on whose recommendation of healthy books, the bank goes ahead and sanctions funds. However, a more holistic approach is required to mitigate the risk of NPAs. It is necessary that independent credit check must be promoted to avail the loan, monitor activities after debt is sanctioned and risk mitigation checks are put in place to ensure minimum risk exposure and prevent wilful default proactively.
- Enterprise Credibility Score should be promoted based on the framework including Management Information (ability to run the business, stake in the business, access to finance), Business Information (assess the ability to generate profits, gauge the operating efficiency, ascertain the customer profile and concentration risk and market standing of the business and promoters), financial information (banking conduct, liquidity position, investment in productive assets), credit worthiness (payment discipline for various financial liabilities, timely payment for utilities and other obligations) and Compliance (compliance with statutory requirements and registration status under applicable regulations).

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