

**A comparative study of Non Performing Assets in India in the
Global context - similarities and dissimilarities, remedial measures**

A paper by

By

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About the Author

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Abstract

Financial sector reform in India has progressed rapidly on aspects like interest rate deregulation, reduction in reserve requirements, barriers to entry, prudential norms and risk-based supervision. But progress on the structural-institutional aspects has been much slower and is a cause for concern. The sheltering of weak institutions while liberalizing operational rules of the game is making implementation of operational changes difficult and ineffective. Changes required to tackle the NPA problem would have to span the entire gamut of judiciary, polity and the bureaucracy to be truly effective.

This paper deals with the experiences of other Asian countries in handling of NPAs. It further looks into the effect of the reforms on the level of NPAs and suggests mechanisms to handle the problem by drawing on experiences from other countries.

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1. Introduction

After nationalization, the initial mandate that banks were given was to expand their branch network, increase the savings rate and extend credit to the rural and SSI sectors¹. This mandate has been achieved admirably. Since the early 90's the focus has shifted towards improving quality of assets and better risk management. The 'directed' lending approach has given way to more market driven practices.

The *Narasimhan Committee* has recommended prudential norms on income recognition, asset classification and provisioning. In a change from the past, Income recognition is now not on an accrual basis but when it is actually received. Past problems faced by banks were to a great extent attributable to this.

Classification of what an NPA is has changed with tightening of prudential norms. Currently an asset is "non-performing" if interest or installments of principal due remain unpaid for more than 180 days.²

¹ Talwar, S.P (2001)

² RBI (2002c)

2. Overview of Performance

There have been noticeable improvements in the financial health of banks in terms of asset quality. Further, pre and post reform NPA levels are not strictly comparable as there has been a significant tightening of accounting norms³.

2.1 Based on Gross and Net NPAs

Exhibit 1

Year	Gross NPAs		Net NPAs	
	Amount (Rs Crore)	As a percentage of total advances	Amount (Rs Crore)	As a percentage of total advances
1992-93	39253.14	23.18	No Data	
1993-94	41041.33	24.78	19690.74	14.46
1994-95	38385.18	19.45	17566.64	10.67
1995-96	41660.94	18.01	18297.49	8.9
1996-97	43577.09	17.84	20284.73	9.18
1997-98	45652.64	16.02	21232.13	8.15
1998-99	51710.5	15.89	24211.49	8.13
1999-2000	53294.02	14.02	26187.6	7.42
2000 - 01	54773.16	12.4	27968.11	6.74

Source: Muniappan G. P. (2002b)

The ratios of both have been consistently improving.

2.2 Based on Loan loss provisioning

The net NPAs⁴ have continually declined from 14.46% in 1993-94 to 6.74% in 2000-01. RBI regulations require that banks build provisions upto at least a level of 50% of their gross NPAs. The current provisioning is 35% of gross NPAs.

³ Muniappan G. P. (2002b)

⁴ Portion of NPAs which is not provided for

2.3 Sector Wise Split-up

As can be seen, the main culprits are not the priority sectors or PSU's, but are the large industries. If government sops to agriculture and SSI's are excluded, the NPA in the priority sectors is even lower.

Exhibit 2

Borrowing Segment-wise distribution of Gross NPAs	Gross NPA on March 31 2001	
	Amount (Rs Crores)	Percentage of Total NPA
Public Sector Units	1334.05	2.44
Large Industries	11498.1	20.99
Medium Industries	8658.69	15.81
Other non priority Sectors	9516.62	17.37
Agriculture	7311.4	13.35
Small scale industries	10284.97	18.78
Other Priority sectors	6169.33	11.72

Source: Muniappan G. P. (2002b)

The problem India faces is not lack of strict prudential norms but

1. The legal impediments and time consuming nature of asset disposal process.
2. 'Postponement' of the problem in order to report higher earnings
3. Manipulation by the debtors using political influence

A perverse effect of the slow legal process is that banks are shying away from risks by investing a greater than required proportion of their assets in the form of sovereign debt paper.⁵

The government recently enacted the Asset Reconstruction Ordinance to try and tackle the problem. It gave wide ranging powers for banks to dispose of assets and allowed creation of Asset Reconstruction Companies for this purpose.

⁵ Ram Mohan T.T (2002)

3. Country-wise Analysis

3.1 China

Causes

1. **Moral Hazard:** The SOE's believe that there the government will bail them out in case of trouble and so they continue to take high risks and have not really strived to achieve profitability and to improve operational efficiency⁶
2. **Bankruptcy laws** favour borrowers and law courts are not reliable enforcement vehicles.
3. **Political and social implications** of restructuring big SOE's force the government to keep them afloat.
4. Banks are reluctant to lend to the private enterprises due to
 - a. Non-standard accounting practises
 - b. While an NPA of an SOE is *financially undesirable*, an NPA of a private enterprise is both *financially and politically undesirable*.⁷

Measures

1. Reducing risk by strengthening banks, raising disclosure standards and spearheading reforms of the SOE's by reducing their level of debt⁸
2. Laws were passed allowing the creation of asset management companies, foreign equity participation in securitisation and asset backed securitisation.
3. The government which bore the financial loss of debt 'discounting'. Debt/equity swaps were allowed in case a growth opportunity existed.
4. Incentives like tax breaks, exemption from administration fees and clearcut asset evaluation norms were implemented.

⁶ Lo, Chi (2000)

⁷ Woo, Wing Thye (2002)

⁸ Bama, B (2002)

3.2 Thailand

Causes

1. **Liberalised capital and current account** and external borrowings with inaccurate assessment of exchange rate risk and risk of capital flight in a crisis.
2. **A legal system that made credit recovery time consuming** and difficult.
3. **Real estate speculators** took massive loans projecting high growth in demand and prices of properties. When this did not materialise all the loans went bad.
4. **Steep interest rate rise** turned a lot of loans into NPAs
5. Inability to correctly assess credit risk

Measures

1. Amendments were made to the **Bankruptcy Act**.
2. **Corporate Debt Restructuring Advisory Commission** was set up for the takeover and restructuring of banks.
3. **The Financial Sector Restructuring Plan (1998)** ⁹ focused on capital support facilities for bank recapitalization and setting up of AMCs.
4. **New rules governing NPA exit** procedures based on international standards were introduced.
5. **Privatisation of government entities** was mooted, but faced strong political opposition for fear of a social backlash.
6. **Adoption of international standards for loan classification and provisioning.**
7. **Caps on Foreign equity ownership** in financial institutions were **removed**.

⁹Devakula, Pridiyathorn (2001)

3.3 Korea

Causes

1. **Directed credit:** Protracted periods of interest rate control and selective credit allocations gave rise to an inefficient distribution of funds¹⁰. The Chaebols' focus on increasing market share and pursuing diversification with little attention to profitability caused tremendous stress on the economy.¹¹
2. **The “compressed growth” policy** via aggressive, leveraged expansion worked well as long as the economy was growing and the ROI exceeded the cost of capital. This strategy backfired when slowing demand and rising input costs placed severe stress on their profitability.
3. **Lack of Monitoring** – Banks relied on collaterals and guarantees in the allocation of credit, and little attention was paid to earnings performance and cash flows.
4. **Contagion Effects** from South East Asia coincided with a period of structural adjustments as well as a cyclical downturn in Korea.

Measures

1. **Speed of Action** - The speedy containment of systemic risk and the domestic credit crunch problem with the injection of large public funds for bank recapitalization were critical steps towards normalizing the financial system.¹²
2. **Corporate Restructuring Vehicles (CRVs) and Debt/Equity Swaps** were used to facilitate the resolution of bad loans.
3. **Creation of the Korea Asset Management Corporation (KAMCO)** and a NPA fund to fund to finance the purchase of NPAs.¹³

¹⁰ Kang, Moon-Soo (2001)

¹¹ Ahn, Choong Tong (2001)

¹² Ahn, Choong Tong (2001)

¹³ Bama, B (2002)

4. **Securitization** KAMCO's recoveries came through asset-backed securitization and outright sales. International investors like the Lone Star Fund participated in the process.
5. **Strengthening of Provision norms** and loan classification standards based on forward-looking criteria (like future cash flows) were implemented.
6. **The objective of the central bank was solely defined as maintaining price stability.** The Financial Supervisory Commission (FSC) was created (1998) to ensure an effective supervisory system in line with universal banking practices.

3.4 Japan

Causes

1. **Investments were made real estate** at high prices during the boom. The recession caused prices to crash and turned a lot of these loans bad.
2. **Legal mechanisms** to dispose bad loans were time consuming and expensive and NPAs remained on the balance sheet.
3. **Expansionary fiscal policy measures** administered to stimulate the economy supported industrial sectors like construction and real estate, which may have further exacerbated the problem.¹⁴
4. **Crony capitalism** to the *Keiretsus*
5. **Weak corporate governance** coupled with a *no-bankruptcy doctrine* was a moral hazard in Japanese economy.¹⁵
6. **Inadequate accounting systems** and information flow makes assessment of loan performance outside a bank in Japan difficult.

¹⁴ Yamaguchi, Yutaka (2001)

¹⁵ ESRI (2001)

Measures

1. **Amendment of foreign exchange control law (1997)** and the threat of suspension of banking business in case of failure to satisfy the capital adequacy ratio prescribed. Legislation to improve information flow has been passed.
2. **Accounting standards** – Major business groups established a private standard-setting vehicle for Japanese accounting standards (2001) in line with international standards.
3. **Government Support** - The government's committed public funds to deal with banking sector weakness.

4. Comparison with other Asian Economies

Exhibit 3 – Comparison of Problems and Solutions Across 5 countries

Country	Causes of Problem	Mechanisms used to solve the problem
India	1. Legal impediments and time consuming nature of asset disposal process.	1. Strengthening of Legal Norms
	2. Manipulation by the debtors using political influence has been a cause for industrial bad debt being so high.	2. Aligning of prudential norms with international standards
	3. Political tool - Directed Credit to SSI and Rural sectors	3. Legal mechanisms including creation of ARCs and partial disbanding of the BIFR
China	1. Moral Hazard - SOE's belief that bailout will happen in a crisis situation	1. Creation of Asset Management Companies for the big four banks
	2. Bankruptcy laws favour borrowers	2. Foreign equity participation in the NPA disposal process
	3. Inefficient legal enforcement mechanisms	3. Raising of disclosure standards
	4. Political & social implications compulsions force the government to keep them afloat.	4. Laws enabling Asset backed securitisation.
Japan	1. Real estate boom and bust	1. Strict action (including closure) for non compliance of capital norms
	2. Time consuming legal mechanisms	2. Securitisation of Real estate loans
	3. Crony capitalism	3. Extensive public funding for bailouts
	4. 'The no-bankruptcy doctrine'	
Korea	1. Directed credit: Interest rate control	1 Swift action in containing systemic risk
	2. The “compressed growth” policy	2. Use of Corporate Restructuring Vehicles (CRVs) and Debt/Equity Swaps
	3. Lack of effective monitoring	3. Creation of Korea Asset Management Corporation (KAMCO) in 1997
	4. Contagion Effects from South East Asia	4. Extensive use of securitization
Thailand	1. legal system that favoured debtors	1. Privatisation of government entities
	2. Liberalised capital and current account. Borrowing were made with inaccurate assessment of foreign exchange risk	2. Removal of caps on foreign equity ownership in FIs was removed.
	3. Real estate speculation - Spike in prices and growth rate projections were wrong	3. Creation of AMCs
	4. Steep interest rate increase turned loans bad	4. Government takeover of banks and FIs
	5. Highly decentralized nature of problem	

The NPA levels in the Asia Pacific for 2000

Exhibit 4

NPLs in Asian Countries: 2000

Country	NPL Ratio (%)
Australia	1.0
Singapore	1.0
Hong Kong	4.5
India	6.0
Taiwan	6.7
Korea	11.2
Malaysia	12.0
Japan	16.0
Philippines	17.0
Thailand	18.0
Indonesia	26.0
China	28.0

Source: Asia Week (Web site)

4.1 Similarities

1. Information quality

Lee and Ahn¹⁶ argue that the capacity of the institutional-governance environment to generate a transparent information base is integral to efficient financial sector development. An index of 'informational quality' is used to evaluate the relative strengths of financial systems. On the aggregate informational quality scale the ranks were India (41th), China (47th), Korea (20th), Thailand (32nd) and Japan (9th) out of 55 countries. The 'structural strength of banks' is relevant as it includes measures of accounting standards, definition and provisioning of NPAs and the quality of

¹⁶ Lee, James Chan and Ahn, Sanghoon (2001)

management. The scores in this category were India (1.7), China (2) Korea (3.9) Japan (5.1) and Thailand (3.5).

2. **Legal systems** – All the Asian countries had weak legal mechanism for asset disposal. This factor prevented early resolution of the problem.
3. **Government funds** – All the countries made extensive usage of government guarantees and funding to try and solve the problem. On the flip side, the problem was created due to the belief that the government would have to bail out the banks in a crisis.

4.2 Differences

1. **Causes of problem** – This varied significantly across countries with real estate, crony capitalism, directed credit and lack of prudential norms being the critical factors.
2. **Business structures** – Structures like the Keiretsus and Chaebols in Japan and Korea and the SOE's in China were responsible for their countries NPA problems.
3. **Macroeconomic and Fiscal Policy**

India and China were relatively unaffected by the East Asian Crisis due to the closed capital account and strong domestic savings. This prevented the *contagion effect* from spreading here.

In Japan, the government 'big bang' spending approach to pulling the country out of recession may have ended up creating even greater NPAs¹⁷

¹⁷ Kang, Moon-Soo (2001)

5. Solutions

Don't Eliminate – Manage!

Studies have shown that *management of NPAs* rather than elimination is prudent. India's growth rate and bank spreads are higher than western nations. As a result we can support a *non-zero level of NPAs which balances the risk vis-à-vis return appropriate to the Indian context.*

Effectiveness of ARCs

Concerns have been raised about their relevance to India. A significant percentage of the NPAs of the PSB's are in the priority sector. Loans in rural areas are difficult to collect and banks by virtue of their sheer reach are better placed to recover these loans¹⁸. *Lok Adalats* and *Debt Recovery Tribunals* are other effective mechanism to handle this task. ARCs should focus on the larger borrowers. Further, there is a need for private sector and foreign participation in the ARC. Private parties will look to active resolution of the problem and not merely regard it as a book transaction. Moving NPAs to an ARC doesn't get rid of the problem. In China, potential investors are still worried about the risks of non enforcement of ownership rights of the assets they purchase from the ARCs. Actions and measures have to be taken to build investor confidence.

Well Developed Capital Markets

Numerous papers have stressed the criticality of a well developed capital market in the restructuring process¹⁹. A capital market brings liquidity and a mechanism for write off of loans. Without this a bank may seek to postpone the NPA problem for fear of capital adequacy problems and resort to tactics like evergreening. Monitoring by bondholders is

¹⁸ Viswanathan R. (2002)

¹⁹ Toshiki, Kanamori (2001)

better as they have no motive to sustain uneconomic activity. Further, the banks can manage credit risk better as it is easier to sell or securitize loans and negotiate credit derivatives.²⁰ India debt market is relatively under developed and attention should be focused on building liquidity and volumes.

Contextual Decision making

Regulations must incorporate a contextual perspective (like temporary cash flow problems) and clients should be handled in a manner which reflects true value of their assets and future potential to pay. The top management should delegate authority and back decisions of this kind taken by middle level managers.

Securitisation

This has been used extensively in China, Japan and Korea and has attracted international participants due to lower liquidity risks. The Resolution Trust Corporation has helped develop the securitization market in Asia and has taken over around \$ 460 billion as bad assets from over 750 failed banks. Its highly standardized product appeals to a broad investor base. Securitisation in India is still in a nascent stage but has potential in areas like mortgage backed securitisation. ICRA estimates the current market size to be around Rs 3000 Crores.²¹

²⁰ Mor and Sharma (2002)

²¹ ICRA (2002)

Effects of Capital Norm tightening

There is a fear that disposal through the provision of excessive reserves may result in a deflationary spiral. A thorough provision of reserves will have no negative impact on the long-term dividends paid to shareholders²². Firstly, it helps restore credibility in the financial system. Further, an adjustment mechanism can be created by which the capital gains and future profits that will result from the disposal of NPAs will pass back to the creditors and taxpayers who incurred the losses today. The swift disposal of NPAs during the Great Depression in the middle of a severe deflationary current helped restore the credibility of the financial system.

Realignment of Performance metrics

Traditional performance measures like ROE and NPA Ratio are not really indicative of performance - A high volume of bad lending today will impact positively on ROE, asset growth and NPA Ratio and only show up 5 years later as NPAs. The complexity of the balance sheet makes it impossible to disaggregate the impact of these actions even if stricter disclosure norms are put in place.

Economic Value of Equity (EVE) (or market value) and Economic Value of Equity at Risk (EVER) are useful mechanisms to handle this problem. EVE is the value of the firm if its assets are instantaneously liquidated (assuming the availability of liquid markets). Book Value vis-à-vis EVE comparisons give an idea of whether the 'fair' value is being reflected. EVER can be computed by using '*what if*' scenarios like downgrading the ratings of assets or changing interest rates. Now, at every stage banks can check if *their actions are consistent with the goal of maximizing EVE, subject to an acceptable level of EVER*.

²² Muniappan G. P. (2002)

Consistency of purpose!

Nachiket Mor²³ has argued that the current organizational competencies, regulatory framework, quality of disclosure and incentive structure *produce an inconsistent framework*, which leads to an unsustainable performance level for a Bank. Micro level issues will have to be addressed in order to root out the problem. Processes at every stage of an assets life impact the overall quality of the intermediation process and so a consistent set of procedures are necessary to handle the problem.

Legal Issues

There have been instances of banks extending credit to doubtful debtors (who wilfully default on debt) and getting kickbacks for the same. Ineffective Legal mechanisms and inadequate internal control mechanisms have made this problem grow – quick action has to be taken on both counts so that both the defaulters and the authorising officer are punished heavily. Without this, all the mechanisms suggested above may prove to be ineffective.

6. Conclusion

The paper stresses the importance of a sound understanding of the macroeconomic variables and systemic issues pertaining to banks and the economy for solving the NPA problem along with the criticality of a strong legal framework and legislative framework. Foreign experiences must be utilized along with a clear understanding of the local conditions to create a tailor made solution which is transparent and fair to all stakeholders.

²³ Mor and Sharma (2002)

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