Syllabus subtopic: Indian Economy and issues relating to planning, mobilization of resources, growth, development and employment.

Prelims and Mains focus: about the NPA crisis in the banking sector: its causes and impact; evergreening of loans

News: The Reserve Bank of India’s (RBI) Financial Stability Report (FSR) said the gross non-performing assets (GNPA) ratio of banks remained the same between March and September 2019, but could rise to 9.9% by September 2020.

What has been the trend on NPAs?

The recognition of NPAs of banks improved after RBI initiated an asset quality review (AQR) in 2015. Prior to that, banks had been hiding bad loans rather than disclosing them transparently in their books. As a result of the AQR, the GNPA ratio shot up from 4.3% in March 2015 to 9.3% in March last year. This ratio could increase to 9.9% by September 2020, according to the latest FSR. The reasons given by the banking regulator for the expected increase include the changes in the macroeconomic scenario, marginal increase in slippages and the denominator effect of declining credit growth.

Does RBI have the full picture on NPAs?

The AQR brought transparency to the NPA recognition mechanism. However, RBI may not have a full measure of the problem of bad loans even now. The December 2018 FSR had indicated a recovery in NPAs. The next one, in June 2019, had said that the bulk of the legacy NPAs had already been recognized in the books of banks. The report even projected a further drop in the GNPA ratio from 9.3% in March 2019 to 9.0% in March 2020. However, the December 2019 FSR says the GNPA ratio would rise close to 10% in September this year. RBI was unable to anticipate that the pile of bad loans would increase.

Is the recognition of bad loans nearing completion?
The central bank says so. However, what has to be kept in mind is that no AQR of non-banking financial companies (NBFCs) has been initiated so far. If NBFCs, especially those that intermediate in the real estate sector, are rolling over or evergreening loans they took from banks, the extent to which banks’ NPAs would rise if such loans turn bad remains unknown.

What about under-reporting of NPAs?

Between the release of the June and December 2019 FSRs, RBI’s risk assessments showed at least 10 banks had understated GNPAs for March 2019. The discrepancies discovered by RBI were disclosed to stock exchanges by the banks. They totalled Rs. 26,546.45 crore. The disclosures follow guidelines of the Securities and Exchange Board of India (SEBI) issued in October 2019 that directed banks to intimate stock exchanges of all under-reporting of bad loans by them, within 24 hours of RBI’s risk assessment reports.

What is the impact of under-reported NPAs?

If the aggregate discrepancies of Rs. 26,546.45 crore disclosed by the 10 banks are incorporated into the GNPA ratio for March 2019, the figure rises to 9.3%. But the GNPA ratio for March 2019 given in RBI’s December FSR is the same as that in the June FSR. Whether RBI will restate the figure to account for banks’ under-reporting of GNPAs that its own risk assessments had found isn’t clear. RBI needs to give the full picture on under-reported NPAs’ impact on GNPA ratio.

What is evergreening of loans?

Evergreening in banking is a practice of providing a fresh loan to repay an old loan. For example, a bank can lend money to a company to pay another bank’s loan. In this way, the first bank can maintain its balance sheet and reduce its non-performing assets (NPAs). The first bank can then extend a similar service to a company which is unable to pay the debts of the second bank. So through evergreening practice banks try to ‘manage’ their balance sheets by circumventing banking laws.

Ever-greening of loans has unfortunately been a widespread practice adopted by banks in the past to ever-green their stressed accounts (and avoid classification of NPAs which would require higher provisioning, compliances and impact profitability). This has led to huge debts getting piled up with borrower
entities who clearly have no capacity to repay such loans, and ultimately results in a situation of hundreds (and in many cases thousands of crores) of bank debt remaining unpaid, a consequence much against the public interest at large.