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Quick fix possible for NPA menace? It's not as tough as you may think

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It is said every generation need not touch the fire to understand that it is hot, but in the case of managing risks in lending, the banking sector seems to be forgetting this adage! It is true that risk existed ever since the first banking transaction happened and the same has always been effectively addressed through a variety of tools and techniques. However, we have been witnessing the effect of poor risk management with unfailing regularity.

The NPA problem is undoubtedly the most pressing issue in the Indian banking sector today. With Gross NPAs reaching 10.2 per cent in September 2017 and the latest Financial Stability Report estimating the same to go up to 11.1 per cent by September 2018, there appears to be little respite from the scourge of NPAs. It is also interesting to note that the share of priority sector in total NPAs declined to 23.4 per cent in 2017, from 41 per cent in 2013. Over the same period, the gross NPA rate of the priority sector advances increased to 6.4 per cent, from 4.5 per cent. That of the rest of the advances went up to 11.8 per cent, from 3 per cent. One can safely assume that the directed lending programmes have not really contributed to much of today's NPA problem.

Barring a few instances, we also see that the nature of the transactions that give rise to these risks are typical lending patterns. Most of them are not complex structures. Even the latest case of Letter of Guarantee fraud is a regular banking transaction. So, why is it that we are seeing repeated instances of similar cases?

The RBI has over the years come up with a number of measures to address the vexed issue of stressed assets. Various mechanisms have been tried out, with independent credit evaluation of the residual debt by credit rating agencies being the latest one. While efforts to address the resolution of the stressed accounts are necessary and are in the right direction, it is also important to address the issue of non-performance much before the asset becomes stressed.

It is important to ensure early recognition of financial distress in the borrower's account. The focus should be on identifying the symptoms that point to potential trouble in a borrower's account. It, therefore, implies that the measures to be adopted should be such that the potential derailers are identified at least 12-18 months before they manifest in the performance of the borrower's business. It is not unknown that certain well-run multinational and private banks pass on 'potential' NPA accounts to unsuspecting banks who fail to identify the inherent risks and have even rushed to 'acquire' the accounts. Any plan to manage the NPA problem should have the following three components:

1. Recognition of incipient sickness
2. Steps for resolution

3. Recovery of dues

The seed of an NPA lies in the performing account. It is essential to have appropriate mechanisms to identify the factors that can potentially impact the performance of the borrower and identify measures to address the same. The process begins with a robust credit appraisal process where the lender ensures the risks are well understood and are of the nature that the bank can afford to take on.

It is essential for lending institutions to understand their risk appetite and ensure the exposures are aligned with the risks. Merely participating in a consortium with the hope that others would have done the diligence or taking on a credit as other well managed banks have also taken an exposure can be dangerous.

The risk appetite of each institution is different and hence, it is important to evaluate the risks thoroughly. It is also important to ensure the credit monitoring exercise is taken seriously. A large number of frauds and consequent NPAs can be averted if the age-old practice of reviewing stock returns and conducting stock audits is done diligently.

Once an account slips in its performance, it is important to make an honest assessment of whether the borrower requires further support and the account should be nurtured or should the lender cut losses and look for exit. More often than not, this decision is not taken on time on account of various reasons, including the issue of accountability.

In most cases, even if incipient sickness is identified, the account is kept afloat by providing ad hoc limits. Laying down a clear process of identifying the accounts that need to be 'let to die' and those that need to be 'worked out' without the fear of accountability and investigations, will help in ensuring the issue of defaults is addressed well in time.

It is essential for banks to integrate the monitoring process with the risk management processes and make sure the warning signals are captured in time and acted upon. The other stages of resolution and recovery of dues have been effectively addressed under the IBC process.

While the various measures introduced for resolution of stressed assets are beginning to bear fruit, it is imperative to bear in mind the basic principles of lending and ensure proper appraisal and monitoring.