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Rising Non-Performing Assets in Scheduled Commercial Banks of India: Is Securitisation a Solution?

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Abstract

Non-performing assets have been hurting Indian banking sector since long time. Narasimham Committee Report on banking reforms introduced the concept of non-performing assets. This was a part of the government's effort to bring in global standards to Indian banking industry. As a part of the same effort in the year 2002 SARFAESI Act was passed enabling Indian banks to securitise the assets. This should have helped in Indian banks to reduce the non-performing assets. This study attempts to find out answer for the same. The data on non-performing assets and assets securitised by all scheduled commercial banks over the period of last ten years is analysed using ordinary least square method of regression. The results indicate that there is a no significant positive relationship between the securitisation and decrease in non-performing assets.

1. Introduction

Non-Performing Assets (NPAs) have been hurting Indian banking sector since long time. In the pre-liberalization period, the origination of NPAs was mainly due to the down swings in agricultural sector, rigid industrial licensing, sector-wise reservation, controlled interest rates and tariff protection[9]. The report submitted by committee on Banking Sector Reforms popularly known as Narasimham Committee Report in 1991[11] brought in many revolutionary changes in the Indian banking sector. One of the important areas of revolution was introduction of the concept of Non-Performing Assets (NPAs).

The realization of introducing some measures to account the bad loans was thought even earlier. In 1985-86 Reserve Bank of India (RBI) introduced a critical analysis for a comprehensive and uniform credit and monitoring by way of the Health Code System. This system on assessment of loan, to a great extent, was unable to reveal the real quality of asset. This was also due to the accounting practices of the banks which allowed them to account interest on accrual basis, thus concealing a proper demarcation between quality assets and bad assets of banks. To enhance the competence of banking industry and to facilitate them to compete in the era of globalization, liberalization and opening up of market, banking across the globe embraced prudential norms for income assessment, income classification and provisioning[16]. India could not have afforded to stay behind in the league. As a result in 1993 the Reserve Bank of India (RBI) issued directives on Income Recognition based on Narashimam Committee Report on banking reforms. According to which banks had to classify their credit portfolio into two parts, first

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being Standard or Performing Assets and second was Non-Performing Asset. Prior to 2001 the classification of NPA was done using the concept of 'past due'. An amount is considered as past due if it remains outstanding for period of 30 days past the due date.

If a loan is past due for more than 4 quarters then such asset would be considered as NPA when it introduced in 1993. However in the year 1994 and 1995 it was reduced to 3 quarters and 2 quarters respectively. With the intention of moving towards global best practices and to ensure better transparency '90 days' overdue norms for identification of NPA was introduced in the year 2004. According to the NPA classification and provisioning guidelines laid down by RBI in the Master Circular on Prudential norms on Income Recognition, Asset Classification and Provisioning (IRAC), the banks are required to segregate the advances as standard assets, sub-standard assets, doubtful assets and loss assets.

The Narasimham Committee had also recommended the formation of an Asset Creation Fund to which public sector banks would transfer their NPAs with certain safeguards. However, the recommendation was not accepted, and banks were internally dealing with their NPAs. Based on this recommendation Debt Recovery Tribunals (DRTs) were established consequent to the passing of the RDDBFI Act, 1993. The scheme of Corporate Debt Restructuring (CDR) was introduced in 2001 outside the purview of BIFR.

These legal mechanism for recovery of bad loans was cumbersome and time-consuming[12]. Besides, many global rating agencies expressed their apprehensions about mounting NPAs in the banking industry. At some point the growth in NPA outpaced the growth in GDP this created further doubts in the minds of global rating agencies about asset quality of Indian banks (Anon, 1998). The chart given below depicts the Gross NPA and Net NPA of Scheduled Commercials Banks in India for decade following banking sector reforms.

The Figure 1 gives a clear picture of the trends in NPAs in India. The net NPA of Scheduled Commercial Banks in India was as high as 11.8 percent in the year 1993. This significantly reduced to 5.5 percent in the year 2002. Furthermore, in the Global NPL Report published by Ernst & Young, India stood fourth with the contribution of 2.3 percent to the total NPA of Asia in the year 2003 whereas the other developing Asian countries like Korea and Philippines contribution is just 1.2 percent and 0.7 percent respectively[13]. This called for an immediate attention of the policy makers and another wave of policy reforms. As a result of this, the Government of India appointed a committee chaired by Sri T R Andhyarujina in the year 1999. The committee in its report strongly felt that the banks and financial institutions should

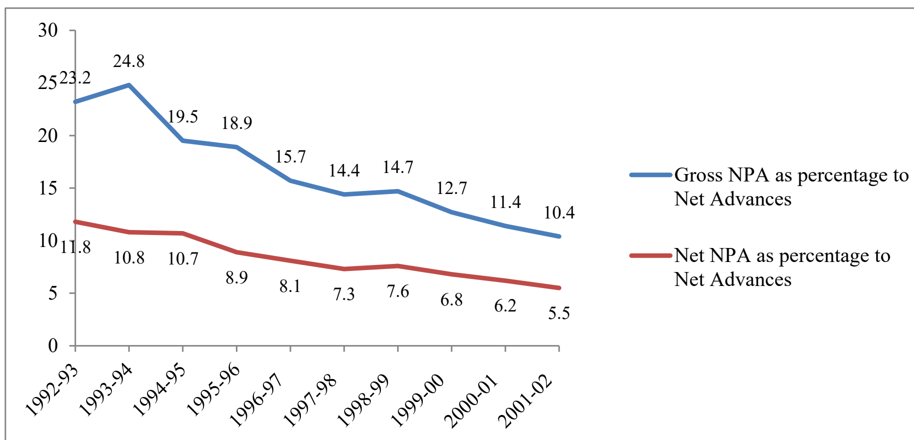

Figure 1. Gross NPA and Net NPA of scheduled commercials banks in India.
Source: Report on Trend and Progress of Banking in India, RBI, Various Issues

be given the power to sell securities to recover dues, hence it recommended the policy makers to allow the banks to initiate the process of asset securitisation. Based on the recommendations of the Andhyarujina Committee, The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002, was enacted on December 17, 2002.

This act provided the security factor for the banks without recourse to civil suits. The act was also passed with the intention of facilitating banks and financial institutions to realize long term assets, manage the problem of liquidity, reduce asset liability mismatches and improve recovery by taking possession of securities, selling them and reducing NPAs.

2. Conceptual Overview of Securitisation

Securitisation generically refers to pooling of cash generating financial assets such as mortgage, loans, bonds etc and issuance of securities in the capital markets backed by the underlying assets. The returns and the repayment of the security so issued solely depend on the performance of the underlying assets. The diagrammatic representation of the concept of securitisation is given below:

The banks or FIs who is also called originators intending to securitize should identify the assets or pool of assets to be securitized. Some basic conditions included the pool of assets should carry identical dates of interest payment and maturities and should be homogeneous in nature. For instance all the housing loans, vehicle loans, credit card loans with the similar maturity can be a pool of asset for securitisation. The assets then needs sold to a Special Purpose Vehicle (SPV) or Asset Reconstruction Companies (ARC) for a cash consideration. SPV/ARC then issues securities based on the underlying pool of assets to the investors. The whole process will be monitored by Trustees appointed by SPV/ARC for the governance purpose. Subsequent to the issue, these securities may be allowed to be traded in the secondary market. To attract investors, SPVs generally rate their issues by credit rating agencies and in some countries rating of issues is mandatory. If the underlying pool of loans are mortgages, the securities issued based on the this pool is called Mortgage Backed

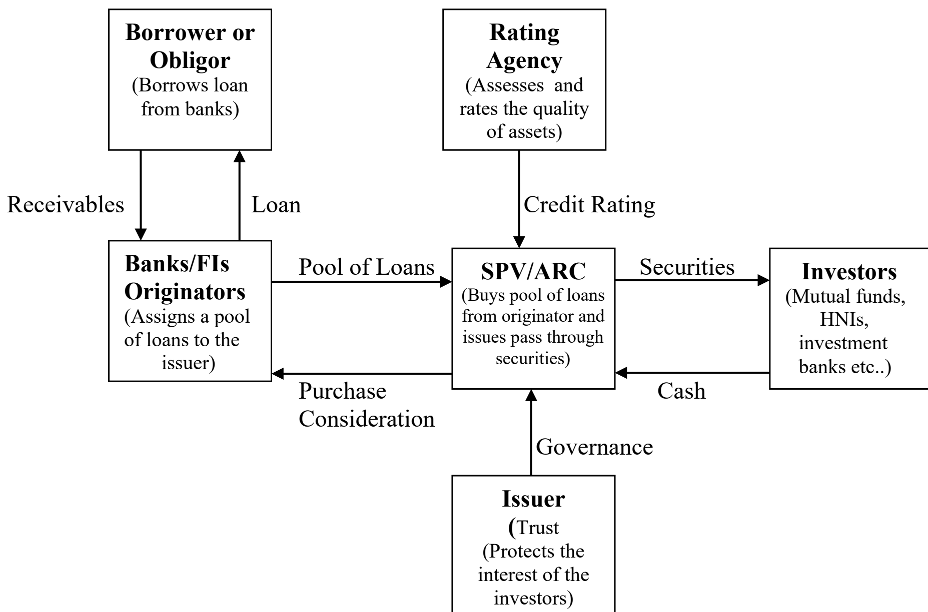

Figure 2. Concept of securitization.

Securities (MBS), if the underlying pool of loans are non-mortgage loans with some collaterals the securities issued is called as Collateralised Debt Obligation (CDOs) and the underlying pool of loans are credit card receivables, personal loan, education loan etc. the securities issued is called as Asset Backed Securities (ABS).

The original idea of securitisation was to enhance the liquidity in the residential mortgage market. It also reduces credit risk of the originator. Structural advantage from securitization arises from the flexibility it provides in transforming cash flows and risks of the pool of underlying assets into those of the securities issued on the pool. The traditional plain vanilla securitisation model as explained in Chart No. 2, plays an important role in intensification of the lending culture by providing the originators with an avenue to free up the balance sheets. Securitisation also improves the balance sheet liquidity by converting the long-term and illiquid receivables into funds which can be used for investing in value enhancing projects. In addition, securitization provides an opportunity to increase the efficiency of their portfolio and diversify the idiosyncratic risks[5].

Securitisation concept has a long history throughout the world. The Federal Deposit Insurance Corporation was established by the US government in 1933, to defy the devastating effects of the Great Depression on banks and financial institutions. Thereafter in 1980s, due to a change in the regulatory framework that allowed large number of banks with high risk policies to enter the real estate led to the real estate crisis which destabilized the capital market. As a result, the US formed the Resolution Trust Corporation in 1989 and Japan, Spain, Chile and many other European countries joined the league subsequently. This was how the concept of securitization and ARC took its birth. Since then lot of innovations in the model increased the popularity of this concept. The idea initially when conceived, was supposed to be a tool to reduce the Non-Performing Loans (NPLs) or NPAs. However, now even standard assets are sold to ARCs to move the blocked funds.

3. Securtisation in India

Securitisation in India has its origin in early nineties, with CRISIL rating the first securitisation program in 1991-92 between Citi Bank and GIC Mutual Fund. Initially it was started as a device for bilateral acquisitions of portfolios of finance companies. These were forms of quasi-securitisations, with portfolios moving from the balance sheet of one originator to that of another. Through most of the nineties, securitisation of auto loans was the bastion of the Indian markets. Since the year 2000, Residential Mortgage Backed Securities (RMBS) have fuelled the growth of the market. This provided Indian banks a new avenue for NPA management.

The growth in the Indian securitization market has been largely invigorated by the repackaging of retail assets and residential mortgages and of late by single corporate loans sell-offs by banks and other financial entities. The table given below depicts the growth in assets securitized by SCBs;

Table 1. Trend in non-performing assets and assets securitised by scheduled commercial banks

Year	NPA (Rs. in bn)	Assets Securitised (Rs. in bn)
2001-02	708.61	36.8
2002-03	687.17	77.8
2003-04	648.12	139.3
2004-05	593.73	308.1
2005-06	510.97	249.6
2006-07	504.86	369.3
2007-08	563.09	650.3
2008-09	683.28	544.7
2009-10	846.98	425.9
2010-11	979.22	769.4
2011-12	650.19	805.0
2012-13	986.09	885.0
2013-14	1423.83	1598.0
2014-15	1758.41	1750.0
2015-16	3498.20	2377.0

Source: Report on Trends and Progress in Indian Banking, Various Issues[6]

From the table it can be observed that NPAs of the SCBs are increasing in the slow pace while assets securitized by scheduled commercial banks are growing ever since its introduction in the year 2002. It increased to Rs. 769.4 bn in the year 2012 from Rs. 36.8 bn. Despite of this growth, Indian securitisation market is not free from hurdles. These issues can be broadly classified as regulatory issues, taxation related issues and legal issues. The main regulatory issue is pertaining to stamp duty. This accounts for the major chunk in the regulatory costs and the stamp duty on transfers of the securitized instrument is again a major hurdle. Some states do not distinguish between conveyances of real estate and that of receivables, and levy the same rate of stamp duty on the two. Stamp duty being a concurrent subject, specifically calls for a consensual legal position between the Centre and the States. Similarly the ambiguous tax laws in recognizing the income as well as the issues in listing the securities in the stock exchanges are not helping the securitisation market in India.

4. Role of Securitisation and Asset Reconstruction Companies in NPA Management

Authors in[1] argued that bank lending channel strongly depend on bank's capacity to originate, repackage and sell their loans. Further they opined that securitisation increases the banks to lend new loans and they will be immunized to the monetary policy changes. Author in[8] concluded that developing countries cannot obtain low-cost, long-term loans during financial crises. Thus, securitisation of future flow receivables can help investment-grade public and private sector entities in these countries obtain credit ratings higher than those of their governments and raise funds in international capital markets.

Many researchers found positive relation between securitisation and overall credit risk of banks and found evidence that securitisation reduces credit risk[2,3]. Thanks to securitisation, now banks can cleanse its balance sheet by assigning its NPAs and by selling of stressed assets to an ARC improving the bank's capital adequacy ratio. The non-performing or sub-performing asset in the portfolio of a bank obviously amplifies the risk of the whole portfolio. Reduction in this risk positively impacts the rating of a bank and along with optimising the banks overall portfolio. This can be achieved by securitizing such loan or outright sale to ARCs[7,15]. Hence securitisation has become a strategic tool for NPA management and improving the bank's efficiency over the period of time.

The research has been undertaken to find out the association between non-performing assets and securitization in the context of scheduled commercial banks in India.

The data for the study is taken from the secondary sources such as annual report published the banks and reports published by RBI. The research studied all 46 scheduled commercial banks except foreign banks. The bank which was into asset securitization is coded as '0' and bank which was not into asset securitization is coded as '1'. Similarly, the banks which were having net NPA ratio more than industry average was coded as '0' and banks with net NPA ratio less than industry average was coded as '1'. The chi-square test is used to test the significance of the association between the securitisation and NPAs.

5. Results and Discussion

The cross tabulation of banks involvement in securitization and NPAs is given in the Table 2 below.

From the table it can be observed that a total of 21 banks had an Net NPA Ratio more than industry average (45 percent of the total) and 16 of these were the banks which had no securitization done during the year (76.2 percent of the banks NNPAs above industry average) and 5 of banks which securitized during the year (23.8 percent of banks NNPAs above industry average). Further, a total of 25 banks had NNPAs below industry average, out of which 16 banks that had no involvement in securitization and 9 banks that securitized their assets during three year.

Table 2. Cross tabulation banks involvement in securitization and NNPAs

			NPA		Total
			NNPA Above Industry Average	NNPA Below Industry Average	
Securtisation	Banks not Involved in Securitisation	Count	16	16	32
		Expected Count	14.6	17.4	32.0
		% within Securtisation	50.0%	50.0%	100.0%
		% within NPA	76.2%	64.0%	69.6%
		% of Total	34.8%	34.8%	69.6%
		Std. Residual	0.4	-0.3	
	Banks Involved in Securitisation	Count	5	9	14
		Expected Count	6.4	7.6	14.0
		% within Securtisation	35.7%	64.3%	100.0%
		% within NPA	23.8%	36.0%	30.4%
		% of Total	10.9%	19.6%	30.4%
		Std. Residual	-0.6	0.5	
Total		Count	21	25	46
		Expected Count	21.0	25.0	46.0
		% within Securtisation	45.7%	54.3%	100.0%
		% within NPA	100.0%	100.0%	100.0%
		% of Total	45.7%	54.3%	100.0%

6. Conclusion

From the discussions above it is evident that rising NPA is worry of the Indian banking sector. Even though the NPA as a percentage of advances has decreased over a period of time, but it is still on the higher side comparing the global standards. The policy makers have introduced several policy reforms in order to control the mounting NPAs. One of such big ticket reform was SARFAESI Act in the year 2002 which allowed the banks and financial institutions to securitise their non performing loans. The road for securitisation market in India was full of hurdles such as regulatory issues, taxation and legal issues. However it is growing in a good rate. The analysis of data on relationship between NPAs and assets securitized, the study found that there is a no significant positive relationship between the securitisation and decrease in Non-performing Assets. In the Indian context, securitisation can indeed play a positive role in financial intermediation. Therefore the securitisation market should play a greater role in managing the NPAs in the future to fuel the economic growth. In order to achieve this some changes in the existing system is obvious. Alongside it is also necessary to promote standardization of valuation and it is very vital to eventually enable the trading of these securities on the stock exchanges.

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