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## Identification and resolution of NPA; regaining strength of our banks

Gopal Krishna Agarwal March 8, 2018

Narendra Modi is carrying out economic reforms in the short time available to him and rebuilding a transparent and corruption free business ecosystem, destroyed by crony capitalism under the UPA. The benefits of his decisions will be slow and realised in the years ahead.

In 2014, we inherited feeble macroeconomic parameters in the form of high inflation, slow GDP growth and a weak financial ecosystem. Over the years, the nexus of politicians, financial institutions and corporate world had weakened the foundations of this structure. And, without resolving these issues, we could not have progressed.

There was no middle ground. Either we compromised and continued as such, or demolished the edifice of corruption and built a new structure. Prime Minister Narendra Modi chose the second. The pain was real but so was the malaise.

With unidentified NPA and no surety of what lay beneath the carpet, the job was tough and not for the faint hearted. Even now, the estimated NPAs are of about Rs. 9 lakh crore. Yes, there was scope for a minor deviation, but that wouldn't have been enough. Instead, with adequate provisioning and sufficient liquidity due to recapitalisation, the government has managed to put banks in a position to tide over the crisis.

To understand this better, we must know that NPA has three components. Firstly, there are genuine failures arising out of business risks. Secondly, there's a large chunk of over leveraged loans. And thirdly, a whole lot of fraud is perpetrated by miscreants in the banking system. Once the gross NPA has been identified, government has to deal separately with each of these three components.

Genuine failures need hand holding and formulation of an exit policy. Fraud requires investigation and penal actions on the criminals, apart from strengthening the control and audit mechanism. Finally, bad quality loans and substandard assets need a very careful resolution so that the confidence in the banking institution is not jeopardized, and the money is recovered.

With new legislation such as the Insolvency and Bankruptcy Code, and the resolution mechanism under NCLT in place, the banking sector now has the teeth to bring fraudulent corporate houses to book.

The current banking crisis has its genesis in the UPA regime. The previous government had ignored the existence of NPA and brushed the problem under the carpet. Finally, Prime Minister Modi took the challenge head on and tried to resolve it.

To understand banking and corporate woes, we have to understand the twin balance sheet problem. The present corporate balance sheet is highly leveraged. Their equity and the profitability thereof cannot service the debt they are carrying. In addition, there has been a large-scale divergence of fund without accounting for its end use.

High debt was the result of nexus between people in power, unscrupulous promoters and corrupt officials. This over leveraging helped UPA on two counts, one it helped them satisfy their appetite for unprecedented corruption and secondly, they were able to transfer public money to corporates in the form of debt, resulting in creation of bad quality loans and sub standard assets within the public sector banks, and also artificially jacking up private capital formation. Non Performing Assets (NPA) to the tune of about Rs 9 lakh crore is essentially a result of doling out public deposits to a select few corporate houses, through a network of shell companies and large-scale money laundering.

If any government chooses to ignore bad loan and goes on evergreening, i.e. rolling them over, the health of the banks will get jeopardised. New and varied financial deals can always be invented to roll them over, as had been done earlier in the form of structured financial instrument like the Letter of Undertaking (LOU) and Statutory Debts Restructuring (SDR).

Regardless, the moot question is whether under the NDA the health of the banking sector has gone from bad to worse, or are we in the process of fixing a deep rooted problem?

For the first time, the pressure is on defaulting corporates to either pay off or part with their assets and face criminal consequences. When they tried to subvert the action through NCLT, by bidding themselves or through the network of their shell companies, the government proactively blocked this route too.

As a result we see that companies like the Bhushan Steel are now getting bids to be bought over by companies with better management like the Tata's. This way the company does not close, workers continue to remain employed and inefficient management is thrown out. Moreover, financial institutions also get a chance to recover their dues.

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