

Recovery Mechanisms of Non-Performing Assets in Indian Commercial Banks: An Empirical Study

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Abstract

The solution of NPAs and its recovery lies only with proper credit assessment and recovery management mechanism. In a situation of liquidity overhang and economic boom, it is the tendency of banks to lend more compromising asset quality, raising concern about their adverse selection and potential danger of addition to the stock of NPAs. When an asset become NPAs, the recovery wings starts its operations. Performance of various recovery channels of NPAs in Indian banking system is not found to be satisfactory. Improper due diligence, insufficient law to combat against defaulter and externalities of macro-economic variables may be the main cause of weak recovery mechanism process.

The Paper analyse the recovery mechanism of NPAs with its three important wings i.e. recovery through Lok Adalat, DRTs and SARFAESI and its impact on NPA covering the years from 2003-04 to 2016-17. The study is purely based on Secondary data collected from RBI data warehouse. SPSS 20 is used to analyse the data. The study finds that overall recovery mechanism in banking industry is very poor. Among the three wings recovery through DRTs is better than other two.

Key word: Recovery management, Due diligence, Lok Adalat, DRTs, SARFAESI.

Introduction

An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank. A 'non-performing asset' (NPA) was defined as a credit facility in respect of which the interest and/ or instalment of principal has remained 'past due' for a specified period of time. Presently it is 90 days from the date of sanctioning the loan. Non-Performing Assets (NPAs) can be defined as "A loan where the lender has some doubt of is experiencing difficulties in obtaining repayments & irrespective of time frame, the outcome could be a loss of capital" (Sing and Modiyani 2013). Recovery mechanism is a process of planning, testing, implementing the recovery procedures and standards required to restore financial assets in the event of failure of the firm. We all know NPAs ceased to generate income, require provision, increase borrowing cost, affect morale of the employee, and erase capital. In this context recovery of NPAs plays a vital role to sustain the banking industry. Mainly recovery is done through three major tools as are discussed below:

Lok Adalat

Lok Adalat has developed in India by Legal Services Authorities Act, 1987. Otherwise it is called as "People's court", Encouraged by Justice P.N.

Bhagwati, a former Chief Justice of India. Lok Adalat is a non-adversarial system, whereby mock courts (called Lok Adalats) are held by the State Authority, District Authority, Supreme Court Legal Services Committee, High Court Local Services Committee, or Taluk Legal Services Committee. The first Lok Adalat was held on March 14, 1982 in Gujarat. Lok Adalat's help banks to settle the loans by way of compromising between bankers and defaulters of the bad loans through Lok Adalat. Debt Recovery tribunals have been authorized to form the Lok Adalat to decide on cases of NPAs of Rs. 10 lakhs and more. The systems seemed to be more effective for recovery of loans by immediate judgement on the cases referred. Lok Adalat have been useful for mostly recovery on smaller loans. Mobile Lok Adalats are also organized in various parts of the country which travel from one location to another to resolve disputes in order to facilitate the resolution of disputes through this mechanism. As on 30.09.2015, more than 15.14 lakhs Lok Adalats have been organized in the country since its inception. More than 8.25 crore cases have been settled by this mechanism so far.

Debt Recovery Tribunals (DRTs)

Debts Recovery Tribunals (DRT) and Debts Recovery Appellate Tribunals (DRAT) were constituted under

the provisions of the DRT Act for establishment of Tribunals for expeditious adjudication and recovery of debts due to Banks and Financial Institutions and for matters connected therewith. DRT has also been given the power to adjudicate the applications filed by the Borrower/Mortgagor against the action of the Secured Creditor initiated under the Securitization Act. The Debt Recovery Tribunals have been established in India under an Act of Parliament (act 51 of 1993) for speedy swift recovery of debts due to banks and financial institution's by GOI. The debt recovery tribunal is also the appellate authority for appeals filed against the proceedings initiated by secured creditors under SARFAESI Act 2002. At present there are 33 DRTs and 5 DARTs functioning at various parts of the country. In 2014, the government has created six new DRTs to speed up loan related dispute settlement. The leading issue related with debt recovery through DRTs is the slow process of resolution (setting debts and finding end to defaults). Like several other debt recovery mechanisms, the DRTs are slow to work out on pending disputes. Nearly 93000 cases are pending in front of DRTs in the country at the end of 2016. The World Bank estimated that it took 4.3 years on an average in India to resolve insolvency under the old laws, more than twice as long as China. This is one of the worst among the similar economics.

SARFAESI Act:

The law did little until it discovered the magnitude of NPA's impact on the profitability of the bank. SARFAESI ACT was formed in Dec' 2002 based on recommendations of a) Committee on Banking Sector reforms (Narasimham Committee Report II) and b) Restructuring of Weak Public sector Banks (Verma Committee). This Act aims at speedy recovery of defaulting loans and to reduce the mounting levels of Non-performing Assets of banks and financial institutions. The provisions of the Act enable the banks and financial institutions to realize long-term assets, manage problems of liquidity and asset liability disparities and to improve recovery by exercising powers to take possession of securities, sell them and reduce non-performing assets by adopting measures for recovery or reconstruction. The Act provides three alternative methods for recovery of non-performing assets, viz;

- Securitization
- Asset Reconstruction
- Enforcement of Security without intervention of the court

Securitization

Securitization implies the issue of security receipt by raising of funds or receipts by SCs / ARCs. The

Securitization company or Reconstruction company raises from the Qualified Institutional Borrowers (QIBs) by way of schemes to acquire funds. They have to maintain proper book of accounts separately for each and every acquiring asset on the investments made by QIBs. Qualified Institutional Buyers are those who have expertise and sound knowledge to evaluate and make their investment in the Capital Markets.

Assets Reconstruction

- Assets Reconstruction companies buy the NPAs from Banks and take measures to recover the bad loans amount from the borrowers and also empower with,
- Proper Management of the borrower business,
- Change of management in the business
- Take Over
- Sale or lease,
- Restructuring the business of the borrower,
- Rescheduling of the repayments of debts payable by the borrower,
- Possession of Secured assets.
- RBI permitted ARCs to convert the debt / outstanding loans of borrowers in to "Equities" as a functional process of restructurings the loan amount of NPAs.
- Shareholding shall not exceed 26% of the post converted Debt Equity as a reconstruction.

The companies under equity reconstruction, as a part of Enforcement of Security interest, the permission given by Secured Creditors holding should not be less than 60% of the amount outstanding to a borrower as against 75% as on date.

The amount recovered through this process will be used by ARCs, to reconstruct the company's management.

Enforcement of Security Assets

The Act provides notwithstanding anything contained in the Registration Act 1908, for the enforcement of Security Interest without Court Intervention. 1) any security receipt issued by SC / ARC, under sec 7 of the Act, and not creating, declaring, assigning, any right, or title or interest to property except in so far as it entitles the holder of the registered instrument, or 2) any transfer of security receipts, shall not require compulsory registration. At present, there are 19 ARCs in India. But collectively, their capital base is also insufficient to tackle the countries nearly 8 lakh crore NPAs. The main problems in the sector are: low capital base of

ARCs, low fund with ARCs, valuation mismatch of bad assets between banks and ARCs etc. Several steps were taken by the RBI and the Government to bring life into the asset reconstruction activities. In one such step, the government raised FDI in the sector to 100% similarly the ARCs may get a vital role for assets restructuring under the new insolvency and bankruptcy code. In 2016 the RBI amended the SARFAESI act to give the ARCs more power and efficiency.

Bankruptcy Code

Currently, four different forums—High Courts, Company Law Board (CLB), Board for Industrial and Financial Reconstruction (BIFR) and Debt Recovery Tribunal (DRT)—have overlapping jurisdiction, which gives rise to systemic delays and complexities in the process. The bankruptcy code overcomes these challenges and would reduce the burden on the courts as all litigation will be filed under the code before the National Company Law Tribunal (NCLT) for corporate insolvency and insolvency of LLPs, and before DRT for individual insolvency and insolvency of unlimited partnership firms. As the code attempts to create a formal insolvency resolution process (IRP) for businesses, either by coming up with a viable survival mechanism or by ensuring speedy liquidation, it will attempt to curb the number of long-pending cases substantially. The code envisages a new regulator—the Insolvency and Bankruptcy Board of India—while introducing professionals who will handle insolvency cases and insolvency professional agencies to oversee the overall supervision of the Insolvency Board. The code also proposes information utilities that would collect, collate, authenticate and disseminate financial information from listed companies and financial and operational creditors of companies. This will help make the IRP smoother by maintaining a range of financial information about companies.

The IRP could be initiated by a corporate debtor who has defaulted on dues or by creditors, whether financial or operational. When the IRP is on, creditors' claims will be frozen for 180 days, during which time they will hear proposals for revival and decide on the future course of action. Within those 180 days, 75% of financial creditors must agree to a revival plan. If this minimum threshold is not met, the firm automatically goes into liquidation. If three-fourths of the financial creditors consider the case complex and feel it cannot be addressed within 180 days, the adjudicator could grant a one-time extension of up to 90 days on the process.

The code could ensure quicker resolution of NPA problems, especially in PSU banks. In fact, the Financial Stability Report issued by RBI in 2015 indicates that corporate sector vulnerabilities and

the impact of their weak balance sheets on the financial system needs closer monitoring. The time-bound insolvency resolution process would definitely help the financial services industry function better.

The asset quality of Indian Banks has been under close regulatory and governmental monitoring in the recent past. The problem of deteriorating asset quality is not a recent phenomenon in Indian Banking Sector. The quantum and pace with which the asset quality has deteriorated has demanded not only a more vigilant watch over the rapidly deteriorating situation but calls for a serious breakthrough intervention from the regulator, government and other stakeholders to alleviate the rapid fall in the asset quality. The gross non-performing asset of scheduled commercial banks in the Indian Banking sector stands at 5069.22 billion at the end of financial year 2017. The need of the hour is to determine what must be done to solve the problem of NPAs and identify what could be done differently in future. The sheer amount of NPAs has been the foremost drag on the performance of Indian banks. Literature suggests that the focus of banks therefore must be on resolution and recovery of defaulted and sticky loans. The focus of this paper therefore is to present the clear picture of recovery by the important tools and comment on the effectiveness if those tools.

Literature Review

Chipalkatti and Rishi (2007) examined whether weaker Indian banks may have had an incentive to under provide for loan loss provisions (LLPs) and understate gross Non-Performing Assets in order to boost their earnings and capital adequacy ratios (CRARs) by examining bank behaviour in India over the 1996-2002 time period.

Uppal (2009) found that NPAs of public sector banks have increased because of high priority sector advance.

Kaur and Sing (2011) find that the extent of NPAs is comparatively higher in public sector banks.

Gupta (2012) argued that despite the efforts of banks in containing the NPAs, the amount of slippage is still high and public sector banks are more at threat while private sector banks able to consolidate with technology and improved methods.

Salunkhe et al. (2013) argued that for banks it is necessary to keep the level of NPAs low as it impacts upon the profitability of the banks and hence it is necessary to have strong recovery system that should be operated effectively with control and supervision of higher authorities.

Singh (2013) argued Indian banking sector is facing a serious problem of NPAs. To improve the efficiency and profitability of banks, NPAs should be reduced and controlled.

Shaardha and Jain (2016) studied the process and effect of SARFAESI act 2002 and its impact in recovering the Non-Performing Assets in public Sector Banks in India, found that recoveries in NPAs are made easier by the amendment of SARFAESI act 2002.

Gupta and Kesari (2016) found that global economic slowdown and its impact on Indian economy was the primary reason for rising of the NPAs.

Thomas and Vyas (2016) discussed the framework of loan recovery mechanism in Indian banking sector. Paper envisages a 5-E early warning system to prevent loan slippage.

Khosla and Kumar (2017) found that The Indian banks were confronting more than Rs. 90,000 crores NPAs issue and were running under loss of benefit. The common laws of the nation were excessively awkward, making it impossible to way to deal with recoup the awful credits.

Sengupta and Bhardhan (2017) argued that regulatory forbearance does not facilitate resolution and can actually worsen the banking crisis by providing incentives to the banks to defer NPA recognition and delay action. Restructuring of a loan should be the commercial decision of a bank and should not automatically qualify for regulatory concessions in terms of deferment of recognition of NPAs.

Swain et al (2017) study it is inferred that among different mechanisms made by the government, SARFAESI Act-2002 is the most effective reform measure in the Indian banking industry for NPA recovery.

Banana and Chepuri (2016) find that performance of SARFAESI Act is more superior to the other recovery channels throughout the study.

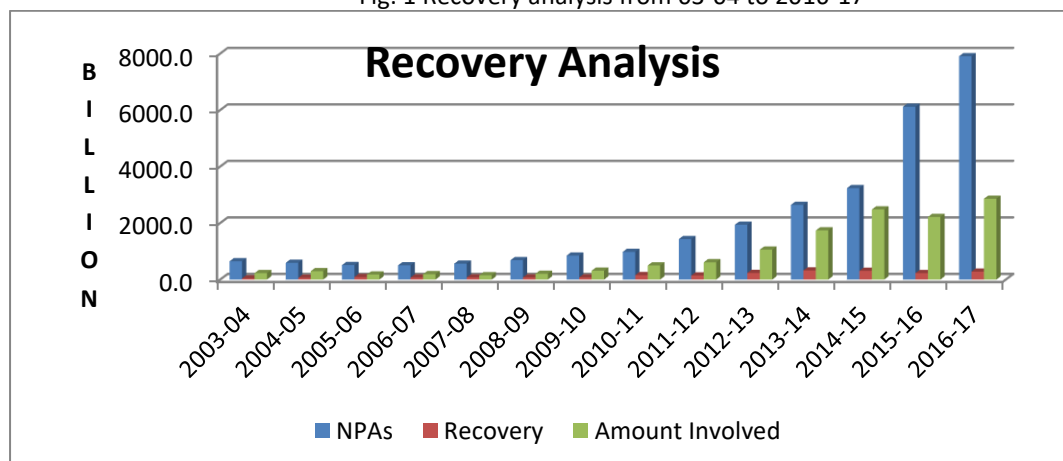
Objective and Methodology

The objective of the study is to analyse various recovery channels and comment on the effectiveness of recovery process in contrast with prevailing Non-Performing Assets levels. The data required for above analysis is purely secondary in nature are collected from Data Warehouse of RBI, beginning form 2003-04 to 2016-17. Analysis is done with SPSS 20 package. Test of homogeneity of variance result found to be significant in our study. Anova is run in between the groups and within the groups to find the significant difference between recovery channels.

Analysis of Data

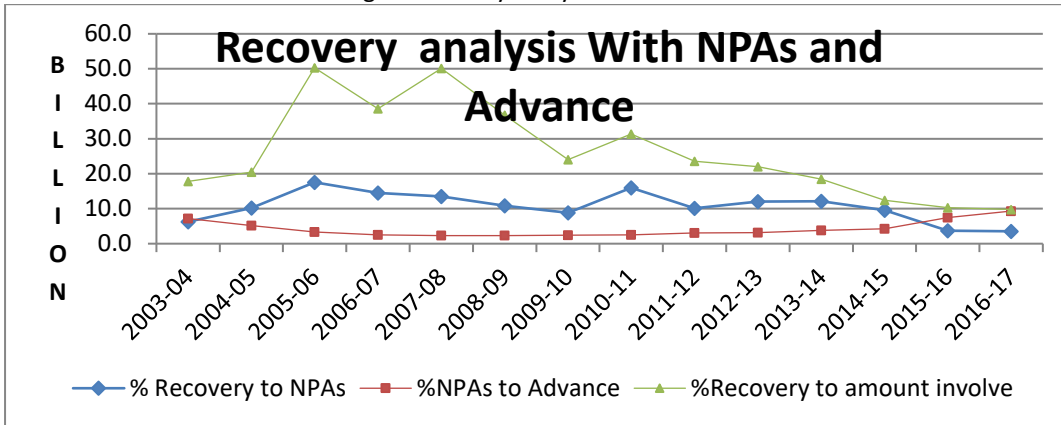
It is clearly observed from Fig: 1 and Fig: 2 that amount of NPAs is increasing at a higher rate than amount of recovery. The total NPAs in the year 2003-04 was Rs. 648.1 billion and in the year 2016-17 Rs. 7902.7 billion moreover amount involve in recovery process is also increasing. The above two fact clearly established that recovery mechanisms is insufficient to cope with the situation. As advance is increasing, NPAs is also rising and the situation may be termed as organisation failure to do correct advance. Again NPAs advance ratio is increasing which again point out the poor quality of advance. Recovery to NPAs ratio is continuously falling from 20011-12 in spite of implementing the BASEL II accord banks and RBI supervision. Accumulation of above fact reduce profitability by demanding higher provision, erosion of capital is also an effect for which Government is planning for merger of public sector banks. Recent frauds, complex law system, political influence, weak internal control system and insufficient supervisory review process may me the cause of weak condition of banks.

Fig: 1 Recovery analysis from 03-04 to 2016-17



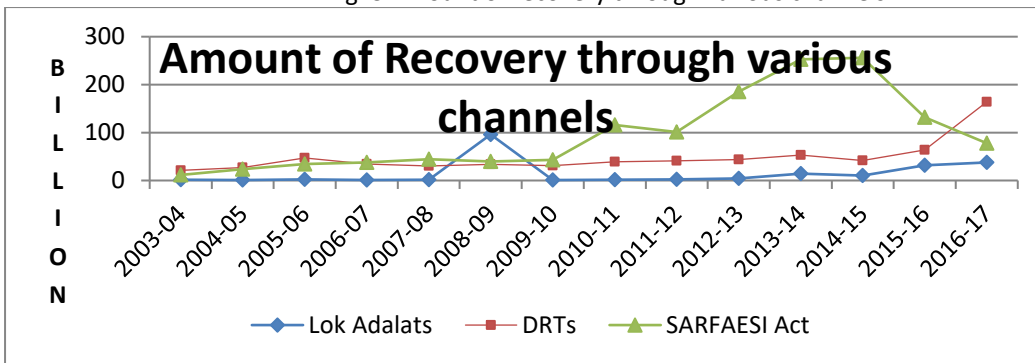
Data Source: <https://dbie.rbi.org.in>

Fig: 2 Recovery analysis with NPAs with Advance



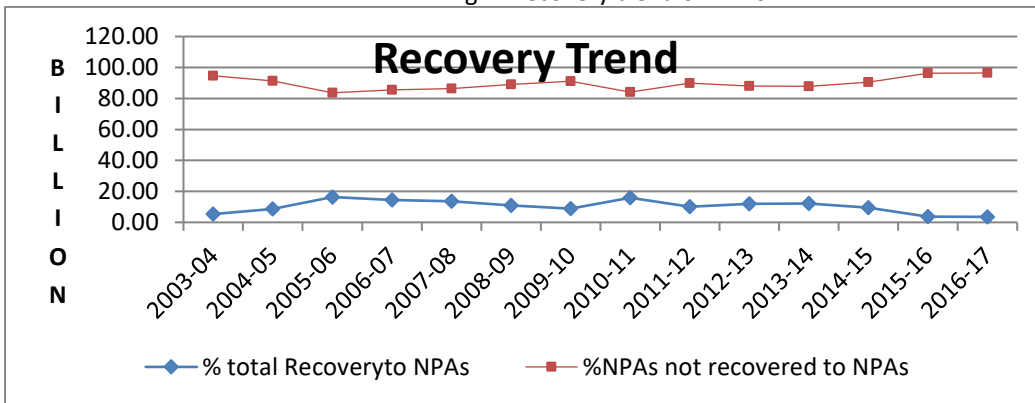
Data Source: <https://dbie.rbi.org.in>

Fig: 3 Amount of recovery through various channels



Data Source: <https://dbie.rbi.org.in>

Fig: 4 Recovery trend of NPAs



Data Source: <https://dbie.rbi.org.in>

It is evident from Fig: 3 recoveries through Lok Adalat highly increased in 2008-09 then marginally increased in 2014-15. Recovery through DRTs increased across the years. In the year 2016-17 it increased to Rs 164 billion compared Rs 64 billion in 2015-16. Recovery through SARFAESI act increased from 2009-10 up to 2014-15 but falls down from 2014-15 and still falling. The data clearly reveals that recovery through SARFAESI act and Lok Adalat was not up to the mark compared to recovery

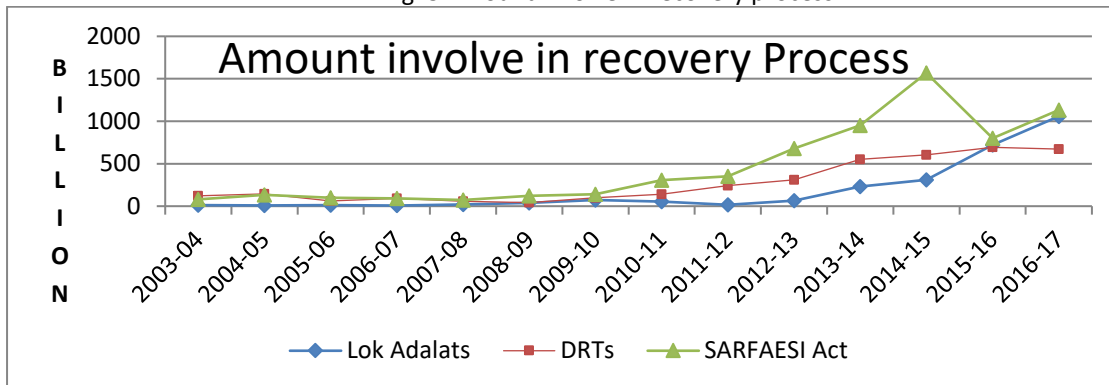
through DRTs. As per Fig: 4 it was found that percentage of recovery to NPAs is 3.54% in the year 2016-17 which is lowest in last 14 years and the ratio is falling from 2013-14. The data clearly established that the recovery mechanism has completely failed.

As per Fig: 5 it is clearly observed that amount involved in recovery process through SARFAESI act is highest among the three recovery channels but amount recovered through above channel is lower

than amount recovered through DRTs and almost equal to amount recovered through Lok Adalat in 2017. This fact clearly exhibits that the existing enforcement law to recover debt is insufficient. In another aspect it can be argued that financial institution is incapable to cope with the legal aspect of advance or they are in a hurry in doing advance

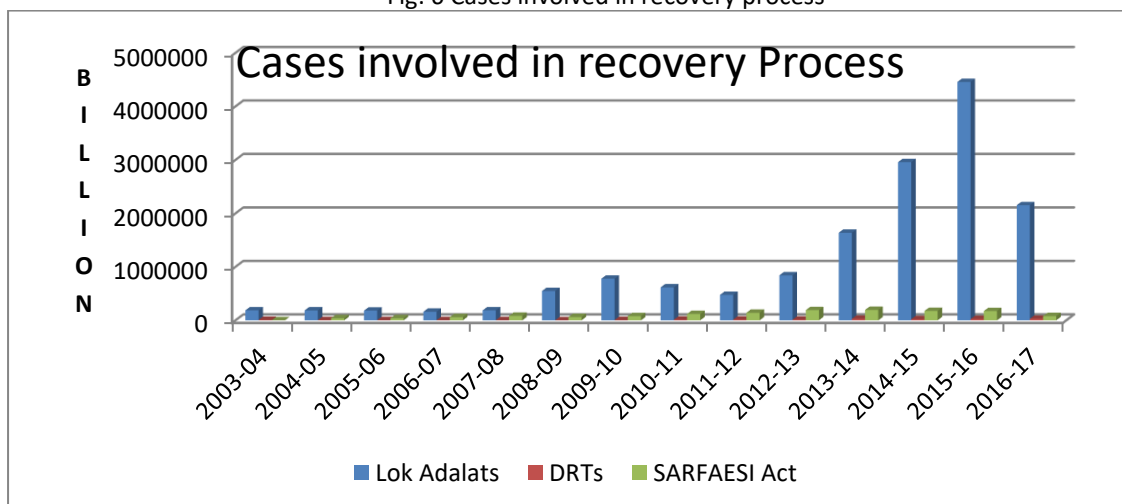
without judging the merit of the loan. As far as numbers of cases are concerned Lok Adalat registered maximum number of cases of default which also exhibits that banks are moving towards Lok Adalat due to its hassle-free, fast, spot settlement and low cost affair for both borrower and lender.

Fig: 5 Amount involve in recovery process



Data Source: <https://dbie.rbi.org.in>

Fig: 6 Cases involved in recovery process



Data Source: <https://dbie.rbi.org.in>

Descriptive

	N	Mean	Std. Deviation	Std. Error	95% Confidence Interval for Mean	
					Lower Bound	Upper Bound
9	14	14.71	26.290	7.026	-.46	29.89
10	14	47.93	35.188	9.405	27.61	68.25
11	14	96.79	82.472	22.041	49.17	144.40
Total	42	53.14	62.708	9.676	33.60	72.68

Test of Homogeneity of Variances

Value

Levene Statistic	df1	df2	Sig.
9.619	2	39	.000

ANOVA

Value

	Sum of Squares	df	Mean Square	F	Sig.
Between Groups	47721.000	2	23860.500	8.199	.001
Within Groups	113502.143	39	2910.311		
Total	161223.143	41			

Robust Tests of Equality of Means

Value

	Statistic ^a	df1	df2	Sig.
Welch	8.518	2	23.426	.002

The descriptive statistic clearly shows that average recovery through SARFASEI from 2003-04 to 2016-17 is higher but data analysis reflects that from the year 2014-15 it falls down rapidly. Statistical analysis clearly exhibits that there is significant difference among the mean score of amount recovered through various channels. The F statistic value (8.199) with p value (0.001) clearly established the fact that the anova result between the groups is significant and there exist difference in recovery amount through different channels. The Levene Statistic (9.619) with p value (0.000) means that the assumption of homogeneity of variance of variables in the model is significant exhibits the variances among the means are unequal. This fact strongly established with robust test of equality of means with Welch statistic 8.518 with p value .002 under 95% confidence interval. The model result shows that recovery amount is highly influenced by recovery channels.

Conclusion

The origin of the problem of growing NPA's lies in the system of credit risk management by the banks. Banks are required to have adequate preventive measures in fixing pre-sanctioning appraisal responsibility and an effective post-disbursement supervision. Banks should continuously monitor loans to identify accounts that have potential to become non-performing. Banks have to exercise powers of inspection to ensure end utilization of fund. Banks may also be given powers to recover loans from the guarantor of the borrower. Statistical analysis clearly exhibits that there is significant difference among the mean score of amount recovered through various channels. This shows that the existing tools are insufficient to cope with the situation. Amount recovered through SARFASEI is much lower than expectation. DRTs consume much more time and as the decision of this tribunal can be challenged in the higher court the recovery process become lengthy. On the other hand Lok Adalat plays a vital role in simplifying the

recovery procedure and the decision of Lok Adalat cannot be challenged in higher court. But as the NPAs over 10 lakh cannot be recovered through this channel the amount of recovery through this channel is lowest and it has limited applicability in enforcement of recovery.

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