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A COMPARATIVE STUDY OF CREDIT RISK MANAGEMENT AND NON-PERFORMING ASSET MANAGEMENT ACROSS AUSTRALIA, CANADA AND INDIA

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Abstract

Banking and financial sector is unique, not only in terms of the functions it performs, but also in terms of the risks that it has to encounter and manage. The risks that impact financial services institutions may be categorized as credit, market, liquidity and operational risks. The risk that the borrowers will not pay interest on their loan and/or fail to repay the loan principal also is classified as credit risk. It is one of the most significant risks faced by financial intermediaries. In fact, credit risk has been found to be a leading cause of many systemic issues in banks across the world over the past few decades.

Keywords: Credit Risk, Asset Management, Non-Performing Assets.

Introduction

When faced with default that could trigger credit risk, banks have to adjust asset values, which in turn impacts the cash inflows. Bad asset quality and losses on account of provisioning norms related to defaulting assets reduce the profitability of banks and also affect its capital. In certain extreme cases, where defaults are too many, failure of bank may also happen if the capital erodes to below regulatory requirements levels. Failure of a bank is very risky as it is likely to have domino effect on the entire economy.

Thus, credit risk is a significant risk for financial intermediaries and a deeper understanding of the same can protect them from being unprofitable. The current study attempts to analyze the position of non-performing assets in Indian banks and find possible solutions to the problem. For this purpose, the study has compared credit losses in Australia, Canada and India. The study has analyzed the banking structure of the selected countries, their approach towards classification of non-performing assets and the level of NPAs they have. Trend and ratio analysis have been used as tools to evaluate the position of NPAs. The study has also presented a discussion on the tools of NPA management being used currently and has highlighted the best practices of other countries that can be used in India to ensure better NPA management.

Since NPAs of banking sector in India are rising at an alarming rate, an analysis of advanced economies with stable credit risk management can help understand best practices in those economies and explore the possibility of employing the same in Indian scenario.

Australia and Canada have been selected for the comparative study because both these countries are economies with credit risk at reasonable level, despite going through various financial crises at the globe level.

Literature Review

“Non-performing loans/ assets have been extensively studied globally to understand their characteristics, implications, trends and the role they play in a country's economy. Some of these existing studies have been reviewed for the purpose of the current study. Apart from these related studies, publications by regulatory bodies in three different countries, books, word economy data from world bank database and websites have also been referred for the study.

Togtokh (2012) discussed the credit risk measurement methodologies used by Mongolian Small and Medium sized firms. The study analyzed financial ratios through Altman's Z-score model. Tripathy and Yadav (2016) discussed non-performing asset and health of assets held by Indian banks in their study, which argued that NPAs were rising in the banking sector in India because of faulty lending policy and making lending to priority sectors mandatory. While studying NPAs in India, Gowri et al. (2013) discussed classification of NPAs, their identification and also provisions prescribed for the same.

In his paper on Credit Losses at Australian Banks, Rodgers (2015) explained the patterns in Australian economy and described in detail the Australian credit loss experience during great depression of 1990 and global financial crisis of 2008.

Financial Stability review (Reserve Bank of Australia, 2017), published by reserve bank of Australia, gives a brief description of the extent, reach, structure and regulations of Australian financial system. It has also discussed Australian deposit and non-deposit taking institutions, their norms, ranking etc. This review is very helpful in understanding the Australian financial structure in depth.

Data Collection and Research Methodology

The data is collected from secondary sources including the web sites of banking regulators in the selected countries. The credit loss dataset for Indian Banks have been extracted from database of Reserve Bank of India reports.

For details of NPA of Australian banks, data has been collected from two regulatory bodies, namely, The Australian Prudential Regulation Authority (APRA) and Reserve Bank of Australia.

For data related to Canadian banks NPAs is taken from Bank of Canada and The Office of the Superintendent of Financial Institutions, which is an independent agency and sole regulator of Canadian banks appointed by the Government of Canada.

For economic data, GDP of all countries is taken from database of world economy and International Monetary Fund database.

Descriptive Analysis

Trend in Non-performing assets of countries under the study

Indian Scenario

In **figure 1**, we can see that the non-performing assets are on a constant rise from 2005 and have reached maximum levels by 2017. The NPA portfolio is increasing at an alarming CAGR of 26.27%. NPA shown over here are an aggregate of Public sector, Private sector, foreign banks, RRBs and small finance banks.

The major reasons cited for this alarming growth of NPAs is reckless lending and regulatory lending to priority sectors.

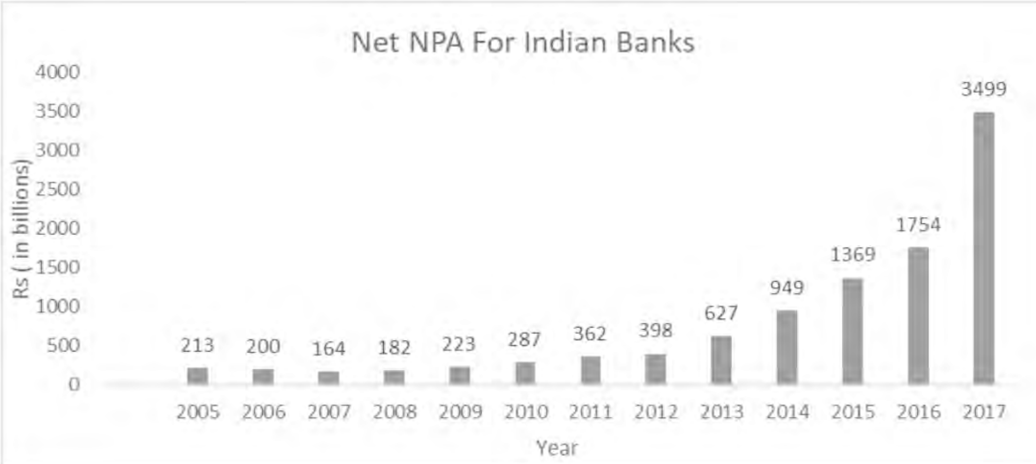

Figure 1 : India's Non-Performing Assets Portfolio

There is a slight decline from 2005 till 2008 but later NPAs show a steady rise of 22.52% on year on year basis from 2009 onwards to reaching a YoY increase of 58% in 2013.The uptrend continues and in 2017 the YoY growth is as high as 99%.

The increase in recent years is much more pronounced for nationalized banks compared to privately-owned banks. In case of the ten worst performing banks in public sector the gross NPAs were 16.4 per cent of gross advances on an average, as on December 2016. This is clear indication of extremely impaired asset quality and stressed balance sheet. The reasons which led to a building up of huge amounts of NPA may be given as :

1. Slowdown of GDP – During the boom phase from 2000-2008 for Indian economy, huge loans were given for capital intensive projects such as power, ports, airports, highway construction, housing etc. These loans turned into bad loans when the global economy went into crisis post 2008. Global financial crisis resulted in erosion of profits, further shrinking company's balance sheets, causing them to default in payment of both internet and principal.

2. Policy Lapses – NPAs started mounting post policy paralysis brought by spectrum and coal mining scandals, as the respective sectors got affected.

3. Domino Effect – Soon all the related and dependent sectors also started experiencing slackness in business and NPA portfolios started growing at a greater speed.

4. Ever–greening Loans – For a long period of time, non-performing loan (NPAs) were hidden by "ever-greening". Due to change in norms brought in by RBI, even these loans ended up being NPA.

5. Sector-wise Analysis - The Five major sectors contributing to NPA are telecom, textile, aviation, mining and infrastructure. The loans generally given to these sectors are by PSBs. Problems faced by respective sectors are:

Mining Sector – The ban in mining projects during 2010 led to a slump in this sector, resulting in turning of huge loans into NPAs. Also the other major contributing factor was cheap import because of international dumping, leading to loss of domestic business as faced by steel sector in India.

Telecom Sector - Severe competition in this sector along with spectrum scam lead to decrease in profitability of companies and bankruptcy in certain cases turning the loans into NPAs.

Aviation Industry – With high oil prices during 2011-12 and not enough risk cover to protect against this upside, the aviation industry ran huge losses adding huge amount of NPAs to the lending banks.

Textile Sector - The ability of the firms in the textile sector to function smoothly was severely impacted by fluctuating raw material costs and shortages, resulting in loans going bad.

Infrastructure – The problems faced by infrastructure sector were largely due to misgovernance and policy failures, leading to missing of time line and delays in projects, ultimately leading to non-payment of dues and rise of NPAs for banks. The other major roadblock for this sector was the issue of acquisition of land on account of controversies and problems in the context of political objections, cultural factors and environmental reasons.

6. **Relaxed Lending norms and Reckless Lending** - When the economy had been booming, the banks were also riding the wave of positivity and had become more open to disbursing loans quickly and on less stringent terms. Often, personalities were given preference over financial viability and credit standing of borrowers. This resulted in NPAs when the borrowers failed to repay. Also, to remain competitive, the banks have been disbursing unsecured loans leading to more instances of NPAs.

7. **Priority Sector Lending** – The regulatory norm of mandatory priority sector lending by banks has forced them to lend to borrowers with limited repayment capacity and further increased NPAs. As per the data available for Public Sector Banks, education loans constitute 20% of their NPAs.

8. **Corporate Lapses and Failure of Adequate Due Diligence Practices** – Firms had borrowed indiscriminately to undertake expansion during the period of economic upswing. In many cases, the expansion plans had not been thought through properly and they failed to increase revenues. Cause these companies to default. Also lapses due to diligence failure, mismanagement by the corporates, willful defaults and business losses on account of changes in business/regulatory environment fueled the growth of NPAs in India.

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Australian Scenario

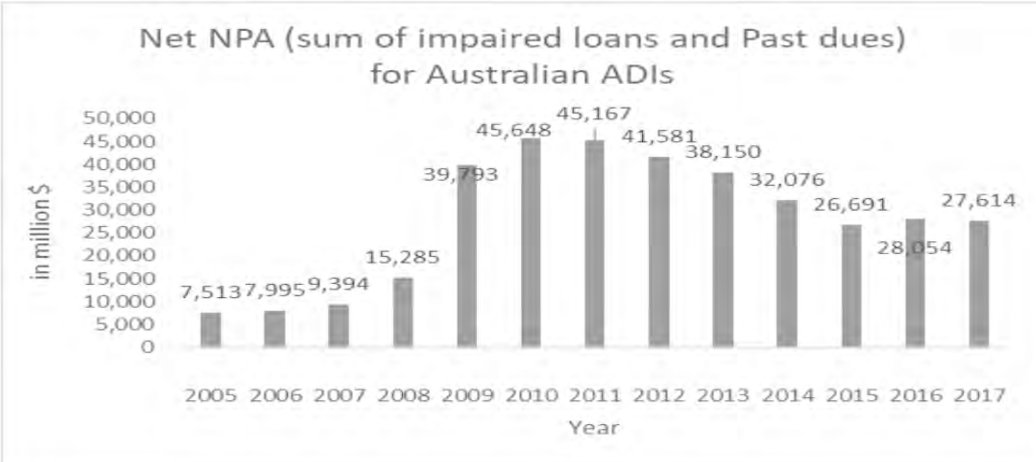

Figure 2 : Australian Non-Performing Assets Portfolio

Figure 2 given above exhibits the Australian NPA data from 2005 through 2017. We can observe that after maintaining a very low level of NPAs till 2008, there is a sudden rise of almost 160% during the financial crisis from 2008 onwards. There were extreme losses related to business lending during the crisis period and for quite some time after it. Losses on household lending did not rise much over this period. Corporate loans the written-off annually at an average rate of 0.8 % for a four year period from March 2009 onwards.

However, the loss due to default by borrowers was much less in Australia during the post-crisis period in 2008 as compared to that after the great depression. As a result, the GDP of the country fell only one quarter.

The main factor behind less severe credit loss during the financial crisis of 2008 as compared to the great depression was conservative lending by banks. The Australian banks fared better during the latest crisis because they had already fortified themselves in response to the issues that came up in the early 1990s. It was also because of the regulatory initiatives such as introduction of risk-based capital requirements.

Ratio Analysis of Banks Non-Performing Loans (NPL) to Gross Loans

There are various metrics to analyze non-performing assets. We will use a comparative study of NPA analysis of India with two developed countries of Australia and Canada for our study. We will use following metrics to analyze asset quality of Banks in three countries:

1. Non-Performing Loans to Gross Loans ratio

The NPL to gross loans ratio is defined by International Monetary Fund as “Nonperforming loans to total gross loans ratio is calculated by using the value of nonperforming loans (NPLs) as the numerator and the total value of the loan portfolio (including NPLs, and before the deduction of specific loan- loss provisions) as the denominator. It is often used as a proxy for asset quality and is intended to identify problems with asset quality in the loan portfolio.” This ratio represents the

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proportion of the loans given by bank that have gone into default.

The issue with too much dependence on this ratio is that one is led into believing that the percentage of NPAs can be reduced by focusing on the denominator, that is, by lending more. However, this assumption rests on another assumption about NPAs resulting from external issues and not from the limitations in the loan evaluation process of the banks.

The fact remains that whatever the ratio, if NPAs continue to remain unresolved, the ailing banks will find it difficult to grow. NPAs will not only erode the capital but also make further lending more challenging.

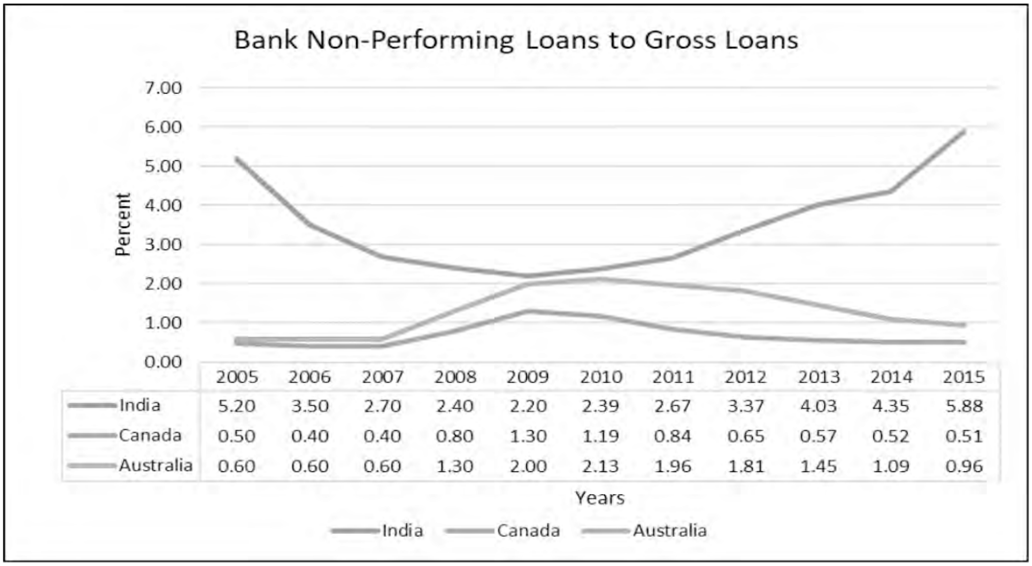

Figure 3 : NPL to Gross Loans Ratio of Banks in Australia, Canada and India

As exhibited in **figure 3,** we can observe the following:

- Indian Banks have a high NPL to Gross Loans ratio as compared to the other two countries under the study. This can be accounted to the developing stage of Indian economy, where more loans are given to still nascent industrial and commercial sector.
- In case of Australia, pre-financial crisis period showed a lower ratio of 0.6% while reaching a high of 2.13% during and post crisis period and again showing a decreasing trend thereafter.
- In the case of Canada, the pre-financial crisis period showed a lower ratio of 0.4% while reaching high of 1.19% during and post crisis period. It again showed a decreasing trend and returned to its initial levels.
- During the past 5 years, non-performing loans to the gross loans ratio rose very steeply for India, increasing by 120%.
- Generally, a 4% mark and lower is considered to be safe while with the latest data of 2017, India is riding high of above 7%.

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Steps taken by Indian Government to reduce NPA

Some of the steps taken by government to reduce NPA levels are

1. **Debt Recovery Tribunals (DRT)** – The regulator provided for establishment of DRTs in accordance with the provisions of recovery of debts due to banks and financial Institutes Act, 1993. This was done mainly with the objective of speeding up the arbitration process for defaulting loans and trying to ensure recovery of dues. There are around 38 DRTs allover India.

2. **Credit Information Bureau of India (CIBIL)** – It is a centralized repository for credit information of individuals and business houses. Established in 2000, it plays a vital role in checking credit worthiness of borrowers.

3. **Lok Adalats –** Since 2001, for settlement of NPAs, lok adalats were permitted by RBI to address such cases. The ceiling of amount of Rs. 5 Lacs can be addressed for doubtful and loss assets. The major advantage of approaching Lok adalats is no or low court fees.

4. **SARFAESI Act –** The formulation of Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 is very important step taken for reduction of NPAs. Under this act, the lending bank can seize the secured asset in lieu of the loan gone bad with notice followed by transfer of ownership if notice is not honored. Further, the bank can dispose the asset to cover losses. The amendments added to this act in 2016 led to wider coverage and tighter norms.

5. **Asset Reconstruction Company-** RBI has given license to 14 asset reconstruction companies to handle the issue of growing NPAs.

6. **Corporate debt restructuring** – Corporate debt restructuring is undertaken with the purpose of changing the loan terms to lower rates and longer period of repayment. The idea is to enable the troubled borrower to repay the loan.

7. **Joint lenders Forum –** This forum is created to bring together lending banks on a common platform so that a defaulting borrower may not try to take loan from one bank to repay the debt of another and create a vicious circle of sorts.

8. **Bad banks –** Formulation of bad bank is in process in India. Bad bank is a body which is willing to take ownership of the troubled loans to try and resolve them through available mechanism and flexible approach. In India, formation of such bank is anticipated to take ailing assets off the balance sheet of public sector banks. This would enable them to continue to lend to viable borrowers, particularly projects important for economic growth and development.

Best Practices Adhered to in other Countries

There are various best practices which can be adopted from Australia and Canada as a solution to India's current NPA issues. The steps taken by these developed countries in overcoming great depression and financial crisis offer precious lessons in credit risk management. There are multiple tools of credit risk transfer (CRT) and their complexities have multiplied over time. Some of the methods that can be employed by the bank to control and lower their credit risk, known as “world's best practices”, are as follows:

1. **Efficient and extensive Data Collection –** Varied and informative data points should be accumulated by banks related to counter parties and cash inflows and outflows. Availability of quality data related to risk is critical for developing models for effective credit analysis and appraisal. As of now there is a dearth of extensive data in the field.

2. **Risk Profiling –** This pertains to the use of latest statistical techniques in the grading process of risk profile of clients. Internal and external models should be employed for retail as well as wholesale banking clients. Such risk profiling and grading can also be used for risk-adjusted pricing of exposures on various clients. Such grading and related pricing information can help banks manage their exposures in line with their risk/return requirements.

3. **Use of Broader Portfolio Models** –Use of active portfolio diversification is an efficient way of managing credit risk of banks. Buying and selling of loans can be done to achieve a balanced portfolio.

4. **Securitization** – In the process of securitization, the existing loans are sold to a special-purpose vehicle (SPV) created for the purpose. It funds the purchase by issuing securities to investors by offering the underlying loans as collateral.

Conclusion

A comparative analysis of the NPA management in three countries, namely, India, Australia and Canada, has been undertaken in this research. Management of asset quality in all the three countries has been analyzed to draw inferences.

Detailed analysis of rules pertaining to the identification of NPAs and the provisions for the same are studied herein. Further, trend analysis of Indian and Australian non-performing assets has been undertaken to understand the changing levels. The study has also discussed the measures taken by Indian government to counter the growing problem of NPA. The best practices in NPA management from around the world have also been identified and summarized to act as a guide for banks in India to tackle the issue of rising NPAs.

Some international practices suggested are efficient credit measurement through use of data analytics and pricing related to credit risk for reduction of current level of NPAs. Also various credit risk transfer measures such as securitization, credit debt obligations and other credit derivative products have also been identified as ways to ease banks stressed assets.

Secondary data of Canadas's Non preforming assets was not available; hence trend analysis for the same was not carried out.

Future researchers can include other developing countries to the study to undertake a comparative analysis. Various models of credit risk measurement can also be studied in detail.

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