■ COMMENT

India needs to do more on bad debts

A number of systems need to be developed if India is to successfully resolve its bad loan problem, says DILIP PARAMESWARAN*

ONE OF THE key constraints for the Indian economy is the accumulation of non-performing loans in the banking system. Recent figures from the IMF show that, at 5.9%, India's gross non-performing loans as a share of total loans are the highest in Asia. Including restructured loans, the figure exceeds 14%.

As banks groan under this burden, they are unlikely to be able to support the lending growth required for the economy to pick up. The Reserve Bank of India has taken the first step towards a solution by conducting asset-quality reviews and insisting that all the non-performing loans be recognised for what they are. It has imposed a deadline of March 2017 for the banks to properly classify loans and make provisions.

While this may increase the stress on the profitability and capital ratios of the banks, it is better to accept the truth than to brush it under the carpet. The capital ratios of Indian banks are already among the lowest, according to IMF, and will come under further stress as the banks go through the inevitable pain. While the government has allocated some funds to recapitalise banks, this is by no means sufficient.

Apart from pushing for greater transparency, the RBI has allowed banks to convert loans into equity with a stipulation that they have to find a buyer for the shares within the next 18 months. The challenge for the banks is to convert the debt to equity at a high valuation, manage the companies in the interim, and identify a buyer. The RBI permits the banks to sell as little as a 26% stake while holding the rest, but potential buyers may not like keeping the banks as co-owners for an extended period.

THE RBI HAS also allowed banks to refinance loans to the infrastructure sector for 25 years with refinancing or restructuring every five years. The question is whether banks will apply this option to viable loans or to mask problems.

However, none of these solutions is a genuine attempt to improve the viability of troubled borrowers. If India's bad loan problems are to be resolved in a meaningful way, a host of supporting systems need to be developed. The recently enacted bankruptcy law goes some way in offering solutions for the resolution of insolvent companies, but more changes are required.

First of all, banks need the freedom to deal with problem loans in the best way possible. Currently they are averse to writing off loans or to sanction additional credit for troubled companies for fear of being accused of underhand dealings. The current RBI regulations are far too constraining for them to try to revive distressed borrowers, as they impose a time limit on re-sales of equity shares acquired through debt swaps, lay down the equity valuation method, and specify the minimum percentage to be sold.

India also needs to develop a strong culture of evaluating credits before the loans are sanctioned and of monitoring the borrowers for early-warning signals of trouble. In this context, it is interesting to note that it is not small-scale industries that have led to this massive accumulation of bad loans, but the medium and large-scale borrowers. So the question can justifiably be asked why the banks tolerated the build-up leverage and did not take action sooner.

THE CONCEPT OF independent insolvency professionals introduced in the new bankruptcy law is a positive move, but they need to come from a variety of industrial management, finance and turnaround backgrounds, rather than merely the legal profession. This will happen only if banks are willing to entrust management of troubled industries to turnaround professionals rather than lawyers with expertise in dissolving companies, backed by appropriate incentive structures. For example, banks may agree on an incentive compensation based on an objective measure of improving the value of the borrowers' business such as a multiple of Ebitda or on specific actionable measures such as completion of specific projects.

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Although asset reconstruction companies have existed in India for many years, they are modest in size compared to the scale of the problem. They have also enjoyed a favourable system of putting up a cash outlay of only 5% (recently increased to 15%) and charging a management fee of 1.5%-2% of the asset value. In addition to this model, other models of outright sales, incentive payments and sharing of recovery values would encourage reconstruction companies to maximize recoveries. Unlike China, India could also consider investing public funds in asset reconstruction companies in order to provide a speedier resolution to the problem.

Any amount of tinkering with rules on recognition of problem loans and provisioning is not likely to lead to a genuine revival or resolution of bad loans. To achieve that, the mindset has to change across the entire range of stakeholders, including banks, turnaround funds, professionals, and even the government.

**Dilip Parameswaran is founder and head of Asia Investment Advisors, an advisory firm specialising in Asian fixed income.*