CAFRAL

CENTRE FOR ADVANCED FINANCIAL RESEARCH AND LEARNING

Promoted by Reserve Bank of India

Non-Performing Asset (NPA) Management

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NPA Management

- The entire credit cycle must be reviewed to plug loose ends.

Credit Underwriting

- In case of corporate banking, KYB (Know your Business) is more important than just KYC (Know your customer). Business model should be studied in detail and you should know your risk return matrix.
- Promoter – Banker contact is very important. Banks must not rely on intermediaries who help with loan syndication but must engage directly with the promoters.
- Ability of promoter to continue to bring in funds in future to ensure scalability of business is important and must be assessed at the beginning itself.
- Must carefully assess and determine the size and source of the promoter's upfront contribution.
- For Small and Medium enterprises, its risky for banks to lend based on current assets – data on current assets and liabilities may not always be reliable.

Monitoring

- Big ticket loan exposures – Too scary to let them fail, hence early identification of problems is essential
    - Disciplined reporting by branches
    - Granular details
    - Portfolio analysis
    - Fortnightly reporting of high value accounts to top management
    - Quick action – irrespective of organization structures, system alert and continuous client contact
- Performing assets to be categorized into P1, P2, P3 depending upon degree of aberrations.
- Stressed assets to be classified into S1, S2, S3 based on degree of weaknesses.
- Consolidate inputs from Inspection reports, Credit Audit and Concurrent Audit report. Compile and put gravity wise issues to facilitate decisions and resolutions.
- Release of working capital funds should only be done based on the progress of the project. Often it is seen that working capital funding is consumed even before production has started.
- Early warning signals
    - Devolvement of LCs/Invocation of guarantees
    - Slowdown in collection period of receivables
    - Slowdown in inventory turnover
    - High concentration of assets in intangibles
    - Substantial increase in Debt Equity ratio

- Receivables from affiliated companies
- Rising sales but falling EBITDA level
- Frequent requests for adhoc facilities
- Issuance of cheques against uncleared funds

Restructuring

Key principles of restructuring

- Identify the problem at an early stage through close monitoring.
- See the problem without any blinkers – Don't have the bias of a lender or promoter while analyzing the problem e.g. lenders will worry whether will it become NPA, will it dilute my stake, etc.
- Financial restructuring must be accompanied by Business restructuring such as: Scale business up/down, change of product mix, hive-off less viable units, induction of strategic investors, etc.
- Equal participation by all stakeholders in the restructuring – its important to know your borrower very well before bringing him to the negotiation table. There must be equitable distribution of cost and benefit between promoter/company and lenders.
- Incremental availability of funds/working capital
- Close monitoring and quick intervention on any warning signals – post-operative care of patient is most critical

Sale of assets to Asset Reconstruction Companies

- Its important to recognize that there is a skill arbitrage between banks and ARCs. Reconstruction of the company requires a different approach and skill set due to the following reasons:
  - Reconstruction is equity business and not spread business.
  - It requires hands-on involvement in putting new management team, managing governance issues, implementing a new business model, etc.
- Banks are usually reluctant to sell to ARCs due to perceived differences in the valuation between them. Banks can use the Bond Market yields (FIMMDA curve) as benchmark discount rates.
- Providing complete detailed information on the assets by the banks to ARCs is likely to result in better valuations. Price determination mechanism should be transparent and should be determined in consultation.
- Reserve price should be announced while auctioning assets to Asset Reconstruction Companies; this is considered a feasible solution as banks are already fixing such reserve price in terms of law whenever initiating action under Section 13(4) of SARFAESI Act. This would lead to automatic price discovery by ARCs.
- Bankers should look at investment in Security Receipts (SRs) so that they can participate in the up side realised on resolution of accounts.

- A possible way to think about restructuring and reconstruction of loan assets is through this two-by-two matrix

Unit	Reliable	Unreliable
UnViable	SETTLE	SETTLE
Viable	Restructure	Change of management/Sale to ARC

Promoter

Points for discussion

1. What are the incentives for the banks to restructure and how can the inertia in banks to take action be avoided?
2. Direct players are: lenders, borrowers and regulator. What is the positive role that other stakeholders can play such as Govt (Central and State), Industry Associations, Media, Analysts, Rating agencies?
3. How can there be efficient exchange of information between lenders?
4. Can better disclosure and dialogue with media/analysts/rating agencies result in credit provision be seen as strength of a derisked balance sheet?

Annexure I

Performing Loans – Illustrative Tracking MIS

DEFAULTS IN LOAN SERVICING	
Overdue < 30 days	
P3	Interest Default
P3	Installment Default
P3	Bills Repayment
P3	Devolvement of LC/BG/DPG <15 days
S1	Bills Repayment
S1	Devolvement of LC/BG/DPG <30 days
Overdue > 45 days	
S2	Interest Default
S2	Installment Default
S2	Bills Repayment
S2	Devolvement of LC/BG/DPG > 30 days
Repayment Commitment to Other Lenders	
P3	Interest / Installment / Devolvement < 30 days
S1	Interest / Installment / Devolvement > 30 days
P3	Frequent return of Cheques/Bills < 6 months
S1	Frequent return of Cheques/Bills > 6 months

BORROWER PERFORMANCE SLIPPAGE	
P3	Current Ratio > 1 < Benchmark
S1	Current Ratio < 1
S1	Current Year Operating Losses > 2 Quarters
S1	Erosion of Net Worth/Accumulated Losses
S1	Stretched Receivables – High Overdue > 180 days
P3	Sales decline in the last 2 Quarters
S1	Sales decline in the last 3 Quarters
S1	Unit Operations Low Key
P3	Management focus on business inadequate

OPERATIONAL WARNING SIGNALS	
S1	Frequent requests for temporary enhancements over line of credit
S1	Non-routing of sales through our Bank operations in the a/c dormant > 30 days
S1	Accounts operated with other banks without Bank's mandate
S1	Deficit in Drawing Power > 30 days
S1	Non submission of Inventory / Book Debt Statement > 30 days

S1	Resistance / non-co-operation for asset inspection
S1	Diversion of funds
S1	Any other Terms of Sanction not complied > 30 days

ON-SITE SUPERVISION WEAKNESSES	
P2	Credit Rating delayed
P3	Unit not inspected > 60 days < 90 days
S1	Unit not inspected > 90 days
S1	Credit lines not renewed < 60 days
S1	Credit lines not renewed > 60 days < 90 days
S1	Credit lines not renewed > 90 days

SECURITY DOCUMENTATION WEAKNESS	
S1	Primary Collateral - Equitable Mortgage not perfected
S1	Loan documents not signed by Guarantor
S1	Charge not registered with ROC by due date
P1	Vetting of documents by Bank's legal team pending
S1	Assets charged under insured or Insurance cover lapsed

Annexure II

From Relationship Management to Recovery Management

Relationship Management			**Recovery Management**		
Classification Ratings					
1	**2**	**3**	**4**	**5**	**6**
Changing Objectives					
Increase Business volume			**Improve collateral**		
Build strong personal relationship			**Control cash flows**		
Build excellent service			**Obtain repayment**		
Maximize value			**Control/exercise oversight on management**		
			Minimize losses		

Annexure III

Ten Basic Ingredients of Problem Loan Management – Crash Course for RM's

1. Thou shall ask for the money back
2. Thou shall price for risk and effort
3. Thou shall identify what will turn into cash and immediately do whatever is necessary to get to that cash before anyone else does
4. Thou shall not grant additional time without tangible consideration
5. Thou shall not rely on hope as a workout strategy
6. Thou shall manage risk and not simply monitor it
7. Thou shall develop a contingency plan and ensure the borrower does as well
8. Thou shall not accept an arrangement that yields less than the exercise of the lender's bare legal rights
9. Thou shall do no harm
10. Thou shall not go it alone