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Impact of Corporate Governance on the Rising NPA's In India

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ABSTRACT

Corporate governance norms seek to reduce the risk of corporate failures, scams and secure the interests of all stakeholders involved. The increasing economic problems resulting from banking failures and mismanagement has created the need to identify and understand the shortcomings of the current corporate governance regime. Mitigating economic risks and increasing bank profitability is crucial to ensure the smooth operation of economic machinery. It has been observed that the continued failure of Indian banks to adhere to established global norms has resulted in a severe breakdown of internal functioning which has adversely affected the profitability quotient of banks. This deficiency has forced the Indian regulator to come out with several measures to increase profitability to revive the sector by infusing capital. The regulator has identified several corporate governance shortcomings that have led to the piling up of bad loans and Non-performing assets. The outbreak of the novel coronavirus further impaired the already strained banking sector. This paper aims to explore the realm of banking sector keeping the NPA and Corporate Governance norms as its key variables. The author(s) point out the factors that involves in the uncontrollable rise in NPA in the Indian banking sector and make suggestions to areas that require improvements.

I. INTRODUCTION

Any nation's economy around the globe relies heavily on its banking sector's health and performance. The main objectives of the banking sector, whether it be private or public is mainly to increase profits and lower the level of non-performing assets. The Indian banking sector has been marred by the rise of non-performing assets directing towards an overall issue of governance norms. The key to success for any banking sector is to regulate the banking operations with the stakeholder's interests combined with effective management techniques. The growth of any economy relies on a well-functioning, efficient and organized banking sector. The need for organization of the banking sector was realized post-independence with

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the nationalization and restructuring of several prominent banking institutions in the country to achieve the broader socio-economic objectives of the State. The financial stability and functioning of a bank become critical to a nation's economic health as any banks failure in the sector could have a cascading effect that would be detrimental to the economy as a whole.

Corporate governance norms developed over a significant period of time seek to effectuate an efficient management method to ensure that banks achieve their maximum profitability without compromising on socio-economic objectives. All these norms are embodied in public surveillance in the form of regulatory compliances, relevant laws and supervisory oversight. The combined impact of all these norms and compliances plays a very important role in the daily functioning of banks in the country and the overall profitability quotient of the institution. The lack of adequate implementation of ideal corporate governance practice and management controls can endanger the solvency of banks. The result of failure to comply with the requirements of a sound corporate governance system can be seen in the 2010s banking crisis which prompted the Government of India to initiate a recapitalization project.

The outbreak of the novel coronavirus further added to the woes of the Indian banking sector with its estimated impact to span 2022 FY as well owing to pandemic induced disruptions which will further degrade the asset quality. The accommodative monetary policy with temporary relief measures focused on growth rolled out by the RBI to adapt to the pandemic scenario has had some positive effect. But the surge in cases and further lockdowns and consequent disruptions could lead to a decrease in credit offtake, which has already declined from 1.1% in November 2021 to 0.4% in December 2021.[3]

II. CORPORATE GOVERNANCE

According to the principles of the Organisation for Economic Co-operation and Development, corporate governance can be defined to include the relationship between the management, directors, shareholders and stakeholders which gives rise to objectives and structure of a corporate institution on the basis of which parameters for monitoring and the method of attainment of the objectives is determined. Further, with reference to the banking sector, the revised Basel norms formulated by the Basel committee states that the purpose of corporate governance is to build trust in the banking system by raising the safety parameters with added emphasis on risk governance in the framework. When it comes to banking, corporate governance refers to the daily banking operations are governed by the management of the bank

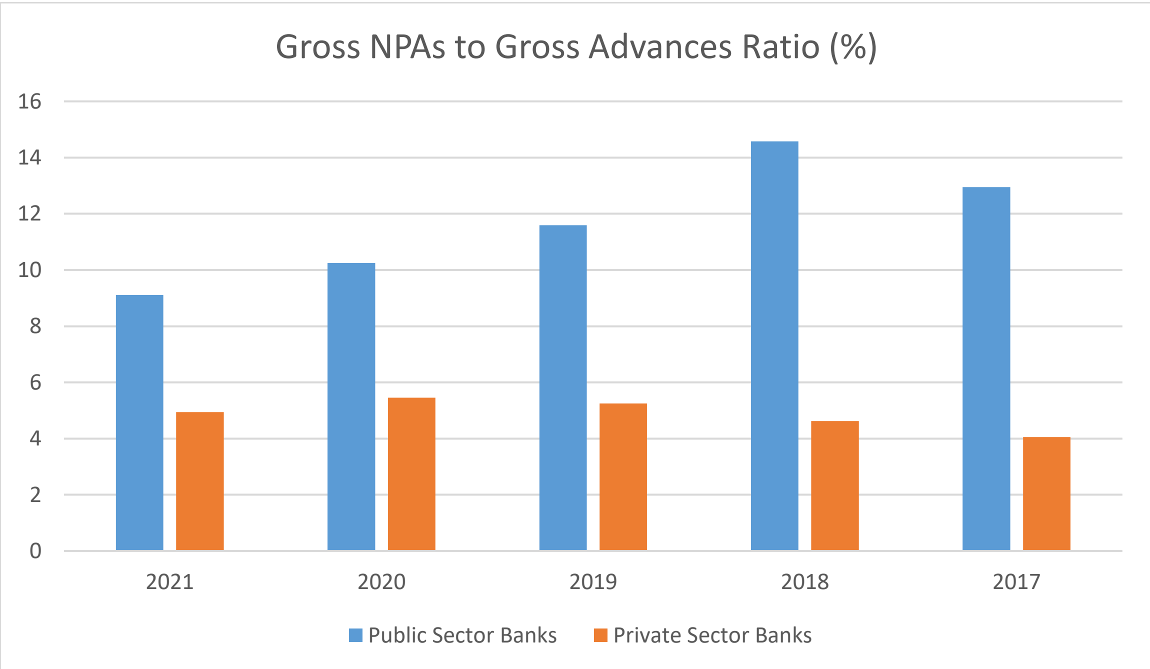
[3] Sunny Verma & George Mathew, *As third Covid wave sets in, bankers see likely NPA surge, growth impact*, (January 10, 2022), https://indianexpress.com/article/business/banking-and-finance/third-covid-wave-bankers-npa-surge-7714998/.

aligned with the shareholder's interest and compliance with regulatory norms with safety measures protecting the interests of the depositors. The adherence to effective corporate governance is paramount for banks as compared to other corporate institutions as the effect of failure would be felt at a wider scale. The Reserve Bank of India and the Securities Exchange Board of India are the regulatory authorities regulating and enforcing the corporate governance norms for banks by periodic review and revisions in the various guidelines and regulations.

III. Reasons for rise in NPAs in India

The most integral and identifiable function of a bank is to forward the money to borrowers in terms of loans to a host of individuals, organizations and companies. Such loans are treated as a source of income for banks as they earn through interest and hence are the assets of the bank. But in several situations when a borrower defaults in the payment of the loan, it is termed as a non-performing asset. Non-performing assets include the assets that cease to yield income for the banks and direct a potential loss as the amount due might not be recovered wholly or even partly owing to several conditions relating to the inability of the borrower to pay back.[4]

As of 2021 Indian public sector banks reported aggregate NPAs of 616615.55 crores, and private sector banks that of 4097039.53 crores. The graph below shows the comparison of the ratio of gross NPAs to gross advances of public and private sector banks in the last five years.



Deficiencies in the governance norms related to evaluation and irrational lending are the

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[4] D. Devpriya & Dr.Rajarajenvanjeko, *A STUDY ON THE IMPACT OF CORPORATE GOVERNANCE ON NON-PERFORMING ASSETS OF SELECTED PUBLIC AND PRIVATE SECTOR BANKS IN INDIA*, 9 IJCRT 2887, 2895 (March, 2021).

leading causes that promote the growth of NPAs in the Indian banking sector. Before the 2008 financial crisis, the banking sector lent companies in excess in expectation of return due to the existing economic boom phase. But as soon as the financial crash hit most businesses were ruined and were unable to pay back and in turn banks suffered as well.[5]

Additionally, delay in approval for mining and other heavy industry-related operations also affects the ability of companies to earn back profits which in turn is one of the leading causes for rising NPAs for public sector banks. Speculative investment in high-risk assets also contributes to the rise of NPAs for banks. While there are situations when the borrower is unable to honour their obligations there are also cases of wilful default by borrowers resulting from misappropriation and fraud. Irresponsible lending activities to ineligible persons without proper evaluation of securities and references is another contributing factor. Diversion of funds away from key operating and profitability areas by banks can also result in an increase in NPAs when combined with the effects of recessionary trends.[6]

Mainly the causes for NPAs can be broadly classified into internal and external factors which are as follows:

(A) Internal Factors

Many times the funds that are borrowed are not used for the intended purpose are a cause of NPAs.

Any defect in the lending process which is based on the three principles of safety, liquidity and profitability is not given due regard. The principles of lending followed by most banks have been set in place to ensure that the borrowers are in a position to pay back their dues and borrow funds for a legal and sound purpose.

Another factor is the lack of technology and inadequate management wherein the necessary decisions to be taken are not taken based on real-time data, and this lack of technological infrastructure leaves an information gap.

SWOT analysis has universal utility and even more so for banks as the analysis can be utilised to evaluate the long term viability and profitability financing operations, and when it is not done properly it can lead to an error of judgement as to the acceptability of a project.

A deficient credit appraisal system that fails to identify borrowers who might potentially default

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[5] Elearnmarkets, *Banking NPA – Causes, Solution and Financial Sector Miseries*, FUNDAMENTAL ANALYSIS (October 27, 2021), https://www.elearnmarkets.com/blog/banking-npa-the-black-hole/.

[6] Dr D.Y Patil & Dr Kamini Khanna, *Good Governance and NPA's of Priority and Non-Priority Sectors of Public Banks in India*, SSRN (2019), https://ssrn.com/abstract=3436632.

in terms of their obligation is another contributing factor. Due to this deficiency banks might advance funds to such borrowers who might be unable to pay their dues.

The human element in the banking system can also lead to deficient managerial decisions which might jeopardize the existing assets of the banks. Cautious selection of eligible borrowers, safeguarding assets by taking securities and diversification of risks as opposed to the concentration of it shall be followed by all bankers to yield the best possible results. The failure to make a proper assessment and subsequent managerial decisions can lead to the formation of NPAs.

Lack of regular follow-ups with borrowers with regards to interest to be paid and the principal sum can lead to a loss of revenue and assets and prevent the detection of any possible future irregularity before it happens.

Incomplete verification and faulty documentation with respect to the requisites of an advance or loan of the borrowers can create obstacles for the banks to recover their losses when the need arises.

(B) External factors

While there are several safeguards set in place by law like recovery tribunals, it is often the case that these recovery tribunals are careless and inefficient at times in recovering the debts owed to banks which leads to further losses.

The public sector banks are majorly affected by wilful defaulters and many notable corporate entities like Kingfisher and Winsome Diamonds & Jewellery Ltd. among other entities are the most widely known wilful defaulters entities making banks lose millions.

PSBs also suffer several losses due to the natural calamities that consequently create an alarming increase in NPAs. Farmers that depend on agricultural loans are unable to pay back the same when weather irregularities ruin crop yields. Other calamities that result in a loss of property further strain the banks' assets and converts those into non-performing ones.

Changing government policies and failure of management that generates sick industries that were initially financed by banks lose out on income generation. This further reduces the liquidity and profitability of such assets of banks.

Failed operating activities due to the dwindling demand of several industries leads to a default on loans. Therefore the banks are left to deal and make provisions for these non-recovered

NPAs.[7]

IV. The effects of the pandemic on NPA surge

As the third wave of the pandemic hits, bankers expect to see a surge in default of loans by borrowers. The extended restrictions of food businesses, malls and other economic activity will have a detrimental impact on the ability of these businesses which in turn leads to further loss for banks that finance such economic activities. Several sectors like tourism, hospitality and retail among others will be the worst hit if the pandemic stretches on for longer along with the restrictions this year. While some luminaries in the field are of the view that making an assessment of the current stage with regards to surge in NPAs is not probable.[8] Disruptions in economic activity caused by the pandemic has resulted in a change of rating from stable to negative by the rating agency Moody's. Capital and profitability of lenders is expected to be negatively impacted as retail segments, small and medium enterprises and corporates' assets will continue to deteriorate.[9] The already declining Indian economy has been further hampered by the outbreak of covid-19 stressing the assets of banks preventing further lending.[10]

As the pandemic brings uncertainty for every aspect of the economy, capital infusions by the government but maintaining consistent transparent financial disclosures and reporting needs to be done to improve the current situation. The Indian regulatory authorities, the RBI and SEBI have introduced several mitigating measures to soften the adverse impacts of the economic slowdown to provide some much-needed relief to the strained economy. The focus of BFSI needs to be on maintaining liquidity with efficient management of the credit risk combined with adequate financial reporting and disclosures. While the RBI has introduced several measures to provide some relief to financial institutions in terms of supervisory and regulatory compliances, the pandemic has still impacted the balance sheet of the sector. Credit risk assessment and other financial reporting considerations need to be considered by banks to adhere to these relief measures. There might still be an appreciable effect on credit quality due to large scale business interruptions which might lead to a liquidity crunch for banks. Business continuity and future growth are being threatened as a result of the assets of insurers getting impacted.[11]

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[7] Dr.G.Syamala Rao, K.Prem Chand & J. Purushotham, *Causes and Effects of Non-Performing Assets in the Banking Sector*, 8 IJMTE 4001–4009 (2018).
[8] Verma and Mathew, *supra* note 3.
[9] Winnie P.H. Poon, Michael Firth & Hung-Gay Fung, *A multivariate analysis of the determinants of Moody's bank financial strength ratings*, 9 IJFMIM 267, 273 (2021).
[10] Asif Perwej, *Effective Management of Customer Relationship Management In Banking Industry*, 2 & 3 MJKG 46,50 (2010).
[11] *Id.*

V. Relationship between non-performing assets (NPA) and corporate governance

With the increasing amount of NPAs within the various sectorial banks in India, there could be different factors that are playing a role, leading to such consequences. It is the result of several irregularities, corporate failures, mis-management and scams that has sparked a scent of public distrust within the banking paradigm. Toxic loan pile has increased in substantial amount over the years that has been identified by the banking sector regulator, RBI and governance failures are its prime reason.[12] There are public surveillance in the form of laws and regulators that controls and monitors the functions of banks, keeping it under the umbrella of checks and balances.[13]

A public sector bank, or PSB are banks where the majority stakeholder is the government of India. PSBs includes all Nationalised banks and the State Bank of India and dominates the commercial banking industry with seventy-five percent of the deposits and seventy-one percent of the advances. Whereas the role of private sector banks was to supplement the performance of PSBs and help in boost the economy. These banks set out loans to the borrowers and create a debt obligation. The problem arises when the same does not repay back the principle amount along with the agreed upon interest even within the extended time period.

Dr. Kajal Chaudhary explains that, *"A company's total sales revenue minus its cost of goods sold, divided by the total sales revenue, expressed as a percentage. The gross margin represents the percent of total sales revenue that the company retains after incurring the direct costs associated with producing the goods and services sold by a company. The higher the percentage, the more the company retains on each dollar of sales to service its other costs and obligations. Loans and advances given by banks to its customers is an asset to the bank. But, when repayment of interest and Principal is overdue, such asset is classified as NPA in the financial reports of banks"*.[14] NPAs are assets that are dormant in nature. They don't have any substantial value neither do they generate any income to the owner. RBI has categorised these assets accordingly as substandard, doubtful and loss assets. These assets that have been NPA for more that twelve months or where the amount has not been written off wholly but are creating losses are the most worry-some of the lot.

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[12] Riya Anil Rai, *Impact of Corporate Governance on Bank Profitability – Post Reforms by RBI and SEBI*, IJM&P (Jan. 28, 2022, 10:12 AM), http://www.ijmp.jor.br/index.php/ijmp/article/view/1473/1896

[13] *Id.*

[14] Kajal Chaudhary & Monika Sharma, *Performance of Indian Public Sector Banks and Private Sector Banks: A Comparative Study*, INTERNATIONAL JOURNAL OF INNOVATION MANAGEMENT AND TECHNOLOGY (Jan. 28, 2022, 10: 30 AM), http://www.ijimt.org/papers/140-M582.pdf

There are several reasons as to why an asset is turning into an NPA. But looking deeper into the banking sector, corporate governance standards are mostly conceptual in nature and very few addresses the actual problem in the banking sector. PSBs are the core foundation of the Indian Banking system and sadly they are burdened with excessive NPAs. These NPAs formed in our present day is due to lower standards of monitoring where multiple projects are left weakly monitored even when the costs increased. Promoter guarantee and equity claims where not audited via forensic analysis and the funds were often misused.[15]

Countless literature supports the co-relation between NPA and corporate governance standards in the realm of banking sector. Increase in NPA shows existence of poor corporate governance standards, making net non-performing assets as its key determinant.[16] Results of regression analysis reveals that private sector banks having higher corporate governance disclosure index scores shows lesser NPA percentage.[17]

VI. Strategies to recover non-performing assets

NPA can be recovered through various strategies that involves change in management, restructuring financially, single-time settlement, or filing a legal suit. Though these are not exhaustive in nature, the author(s) tries to explore these various resolution strategies to point out where there is a lack in corporate governance norm with respect to NPAs.

The bank has to formulate a policy to recover Non-Performing Assets through modes of rescheduling of principle repayment or reduction in the rate of interest. There has to be an effective board of directors in the bank that could strategize such policy structure and get a successful implementation. Similarly, if an asset is an NPA for an extended period of time, there should be a one-time settlement mechanism to recover that asset through various steps such as recovery of full principal with past interest and future interest with repayment premium, full principal with all past interest, full principal with part interest, full principal with full or part interest converted to equity or quasi equity instrument, part principal with remaining part converted to some equity or quasi equity instrument or part principal and remaining part written of.[18] These types of bad assets can be sold off to Asset Reconstruction Companies to clear the

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[15] Kalikant Mishra, *Importance of Forensic Audit in Controlling Non-Performing Assets in Banks*, 3 LIBERAL Stud. 223 (2018).
[16] Sulagna Das & Abhijit Dutta, *A Study on NPA of Public Sector Banks in India*, IOSR-JBM (Jan. 29, 2022, 09: 02 AM), https://www.iosrjournals.org/iosr-jbm/papers/Vol16-issue11/Version-1/K0161117583.pdf
[17] D. Devipriya & Dr. Rajarajenvanjeko, *A Study of the Impact of Corporate Governance on Non-Performing Assets of Selected Public and Private Sector Banks in India*, IJCRT (Jan. 29, 2022, 01:19 PM), https://ijcrt.org/download.php?file=IJCRT 2103354.pdf
[18] Tamal Datta Chaudhuri, *Resolution Strategies for Maximising Value of Non-Performing Assets (NPAs)*, SSRN (Jan. 29, 2022, 01:42 PM), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=871038

balance sheet of the banks. The final resort is filing a suit for recovery and liquidation of assets which is both time consuming and leads to further decline in the asset value.[19]

VII. Key points for development in corporate governance norms

Other than restructuring and management reforms, there should be a mechanism to ascertain whether there is any embezzlement or diversion of funds from the bank through a regular follow up process every financial quarter. This could help keep a track of the account that is turning into NPA to pin point on the exact factor responsible.

The borrowers should be assessed, using modern statistical and other information such as credit history and good will. A healthy relationship between the Banker and Borrower is essential. Recovery of assets must be followed by adhering to all forms of corporate ethics and good practices to retain the good will of the lender in the market. Policy on proper assistance of the borrower to proper utilisation of funds can help build a healthy relationship as well as tracking of funds on the same time. Utilisation of technology and minimised documentation can help reduce transactional costs which in turn increases the profitability in lending to various priority sectors.

VIII. RBI on governance in commercial banks in India

Good Corporate Governance can be achieved through external pressure points like a Regulator. An ideal situation lies where mere compliance with regulatory norms is the basic or minimum requirement for good corporate governance practice. Internal factors like healthy peer competition in best practices or market pressure to reach higher standards should be encouraged. A transparency in discharge of information and operation should be directly proportional to deregulation and operational freedom of banks. Therefore, disclosure and transparency become two key elements in corporate governance regulations and its implementation has to be at the highest level management of commercial banks. This will help keep a balance with the interests of the stakeholders and turning of assets into a Non-performing asset.[20]

(A) Responsibilities of the board of directors

The board of directors of a bank is in charge of the whole operation of the bank, including its culture, governance framework, and approval and monitoring of implementation of the management for the bank's strategic goals. Directors are responsible for the bank's general

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[19] *Id*.

[20] V. Leeladhar, *Corporate Governance in Banks*, RBI (Jan. 30, 2022, 12:01 PM), https://rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/59405.pdf

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interests, regardless of who appoints them. The committees of the board must meet these responsibilities expressed in substantive terms in the following paragraphs by formulating agendas for its meetings and actions taken as a result of those sessions. The committees of the board are expected to keep track of time details of each meeting, discussed subjects required to be summarized, primary discussions, views of individual directors, dissenting viewpoints, decisions made, suggestions made, and board resolutions.[21]

Board Responsibilities in risk appetite, management and assurance

- The board is responsible for managing a solid risk governance system as part of the overall governance framework. A risk governance structure must have clearly defined organizational risk management duties, commonly known as the "three lines of defense." The first line of defense is the “business line”, second is an “independent risk management and a functioning compliance derivative” from the first line of defense and lastly an “independent internal audit and vigilance function” from the first two lines of defense.
- “An independent and competent risk management function” is included in the second line of defense. Through its responsibilities to monitor and report in the risk management function, assists the first line of defense. It is in charge of managing the bank's risk-taking activities, as well as assessing risks and issues.

(B) Risk Management

- Amongst the most crucial aspects of the governance system this is an independent risk management role. This department is in charge of ensuring that the bank stays within their risk appetite. The function is responsible to –
  - design an organization risk governance framework that addresses policies, as well as adequate control practices, to guarantee that a bank's risk analysis, accumulation, surveillance, and mitigation capabilities are proportional to its size, complexity, and credit risk
  - assure that the bank's risk culture is ingrained. This must be accomplished through initiatives such as diligent issuance of instructions, prolonged, training requirements of the concerned staff on the instructions, and bringing to the awareness of the staff instances of risk analysis failures and risk limit breaches, as well as precautionary guidelines

[21] Aanchal Kaur Nagpal, *Strengthening Corporate Governance Norms in Banks – An after dose to a wounded governance system*, VINOD KOTHARI CONSULTANTS (Jan. 29, 2022, 10:00 PM), https://vinodkothari.com/2021/04/corporate-governance-norms-banks/#_ftn1

  - be able to make sure timely and effective danger reassessment by top leadership to stay within agreed-upon risk constraints appetite, develop a solid and plausible framework for coverage, surveillance, and controlling risk through well-defined methodologies and set up an approval process for all fresh products or processes before they can be initiated
  - clearly communicate the bank's assets capacity and only report to the RMCB and be responsible to it. They can establish policies and practices in place to track particular, cumulative, emerging risks, as well as to analyze and quantify the business's exposure to such risks
  - construct an advance detection or a set off mechanism for violations of the bank's risk aversion, as well as “business line” and “risk taker” level restrictions and influence, and, when necessary, counter decisions taken by the first defense line that lead in potential hazard
  - have unrestricted access to all business areas that could pose a risk to the bank, as well as relevant uncertainty wholly - owned subsidiaries, and have full unwavering access to the bank's documents, physical properties, planning and control, and minutes of all consultation process bodies
- The CRO's position and responsibilities must be clearly stated. The CRO will be in charge to coordinate the identification, management, and reduce risk of the bank.

(C) Compliance

- A self-contained compliance function is an important part of the governance framework and the second line defense. This department is in charge to make sure that the bank acts ethically and following all applicable laws and regulations.
- When a bank operates in numerous jurisdictions, it must maintain compliance with all applicable rules and regulations in each of those jurisdictions. The compliance function's organizational structure, as well as its responsibilities, must meet the legal and regulatory requirements of the host country. Individuals with relevant knowledge and skill of the host nation regulations must be assigned compliance tasks particular to each jurisdiction, under the supervision of the CCO.[22]

IX. CONCLUSION

Corporate governance and Non-Performing Assets are interconnected variables in the banking

[22] *Discussion paper on Governance in Commercial Banks in India*, RESERVE BANK OF INDIA (Jan. 31, 2022, 10: 15 AM), https://www.rbi.org.in/Scripts/PublicationsView.aspx?id=19613

system. Analysis indicates that in recent years, there is a significant rise in corporate debt at risk along with an increase in concentration of debt. Various other variables such as bank efficiency and profitability are inter-linked with corporate debt vulnerability and the rise is NPA among the Indian PSBs.[23] The author(s) will conclude this paper with the final comments that good corporate governance practices are not the only solution to reduce bad debts within the banking sector. It is a key element that will improve the overall functioning of the banks and can have a major influence over the rising challenge of NPAs in the banking sector. It is very crucial time to address the issue of NPA with an efficient management, proper documentation and due diligence before sanctioning any advance.[24]

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[23] K. Dhananjaya, *Corporate Debt Vulnerability and Non-Performing Assets in India*, GLOBAL BUSINESS REVIEW (Jan. 30, 2022, 03:09 PM), https://doi.org/10.1177/0972150920935758
[24] Chaudhary & Sharma, *supra* note 14.