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Stressed Assets and Banking in India

Charan Singh¹
RBI Chair Professor
Economics & Social Science
Indian Institute of Management Bangalore
Bannerghatta Road, Bangalore – 560076
Ph: 080-26993818
charansingh@iimb.ernet.in

JagvinderSingh Brar²
Partner, KPMG
jsbrar@kpmg.com

¹Formerly, worked in Punjab National Bank; Reserve Bank of India; and International Monetary Fund, Washington DC. Views are personal.
²Chartered Accountant; Investigative and Forensic Accountant (IFA: Canada); and formerly worked with the World Bank Group. The views and opinions expressed herein are those of Jagvinder Singh Brar and do not necessarily represent the views and opinions of KPMG in India.
Stressed Assets and Banking in India

Abstract

Stressed assets have been rising rapidly in India, mainly in public sector banks. A number of factors can be identified that have led to this situation. These include global slow down, governance related issues, political factors as well as mal-intentions and misconduct. Consequently, significant losses are incurred by the public as well as the Union Government which basically owns public sector banks. The chances of misconduct are substantially large in case of infrastructure project especially under public private partnership. There is need to take this opportunity to undertake extensive research into the factors which have led to deteriorating asset quality in public sector banks.

Keywords: Non-performing assets, stressed assets, bank frauds, PPP delivery models.
Introduction

A significant rise in non-performing assets (NPAs) of the banking system, especially public sector banks (PSBs), is a matter of concern, and the Reserve Bank of India (RBI), Central Government and commercial banks are trying to address the situation. The global slowdown and uncertain market conditions are generally blamed for the grim banking situation. The general refrain of PSBs is that they operate under constraints, are vulnerable to political pressures, and are not on equal footing with private financial institutions as they have to lend to certain segments of the economy in consideration of social responsibilities. However, the trend in stressed assets reveals that higher NPAs are spread-out across the economy, including priority sector. And major stressed sectors are infrastructure, iron and steel, textiles, aviation and mining. Therefore, it would be interesting to examine important causes and reasons to help in correcting the situation.

In a slowing economy, it is natural to assume that NPAs will increase but the primary cause of rising NPAs may not only be economic slowdown but also deficiencies in procedures followed in extending and monitoring credit itself as there are significant differences in approaches pursued by PSBs and private sector banks (PVBs). This difference in approach can be easily isolated if a common commodity is considered, illustratively, tractor financing where anecdotally, NPAs in PSBs were nearly 50 percent of the portfolio, a few years ago. In addition, there could be at play still more factors like mal-intentions, and/or misconduct by the borrowers, many a times with connivance of the bank staff.

It is not the first time that stressed assets have increased in the economy. In 1994, India had recorded higher levels of stressed assets as a percentage of total advances than in 2015 but with prudent policy was able to tame them. Similarly, in recent times, having recognized the rising levels of stressed assets and sectors where stress is occurring, India can address the concerns in the banking sector.

This study documents primary research on the issue based on data and extensive consultations with bankers. In Section II, trends in rising stressed assets (SAs) are briefly presented to set the context. In Section III, a brief but a focused case study of tractors is presented to demonstrate the difference in approach of monitoring and evaluating loan applications. In Section IV, a few more factors are enumerated like attitudinal factors,
governance issues and politically liberal environment. In Section V, borrower misconduct issues are discussed with a case study from infrastructure projects in the PPP delivery model. The misconduct issues may be prevalent in other types of corporate loans, and lessons learned can be used to prevent other large value loans. Section VI presents conclusions and recommendations.

Section II: Trends

In recent years, incidence of NPAs and SAs in PSBs is significantly larger than PVBs and foreign banks, respectively (Table 1).

Table 1: Impaired assets among banks (percent of total loans)

<table>
<thead>
<tr>
<th></th>
<th>All Banks</th>
<th>PSBs</th>
<th>PVBs</th>
<th>Foreign Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 2013</td>
<td>9.2</td>
<td>11.0</td>
<td>3.8</td>
<td>3.1</td>
</tr>
<tr>
<td>March 2015</td>
<td>11.1</td>
<td>13.5</td>
<td>4.6</td>
<td>3.3</td>
</tr>
<tr>
<td>September 2015</td>
<td>11.3</td>
<td>14.1</td>
<td>4.6</td>
<td>3.4</td>
</tr>
</tbody>
</table>

Note: Impaired: Gross + Restructured  
Source: RBI

Though the incidence of NPAs in recent years is higher in PSBs, it is important to understand the context behind such high incidence before any corrective measures can be suggested. PSBs have been the backbone of Indian financial architecture since nationalization of State Bank of India in 1955, followed by more banks in 1969 and 1980. However, as Table 2 reveals NPAs of PSBs have increased significantly in the recent past though the uptrend had been brewing for some time.

Table 2: Incidence of stressed Assets in Commercial Banks

<table>
<thead>
<tr>
<th>End-March</th>
<th>Gross NPAs as percentage of Gross Advances</th>
<th>Net NPAs as percentage of Net Advances</th>
<th>Stressed Assets Ratio (GNPA + Restructured Advances)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>SCBs</td>
<td>PSBs</td>
<td>SCBs</td>
</tr>
<tr>
<td>1995</td>
<td>-</td>
<td>19.5</td>
<td>-</td>
</tr>
<tr>
<td>2000</td>
<td>12.7</td>
<td>14.0</td>
<td>6.8</td>
</tr>
<tr>
<td>2005</td>
<td>5.2</td>
<td>5.5</td>
<td>2.2</td>
</tr>
<tr>
<td>2010</td>
<td>2.4</td>
<td>2.2</td>
<td>1.1</td>
</tr>
<tr>
<td>2015 Sep</td>
<td>5.1</td>
<td>6.2</td>
<td>2.8</td>
</tr>
</tbody>
</table>

*Stressed assets, were defined to include restructured assets, in 2014.  
Note: SCBs: Scheduled commercial Banks. PSBs: Public Sector Banks.
Source: RBI.
PSBs account for a substantially large share of SAs in mining, iron and steel, textiles, infrastructure and aviation as compared to PVBs because of substantially larger exposure to these sub-sectors. Illustratively, PSBs account for 17.6 percent of advances to infrastructure as compared with 8.4 percent of the PVBs, while SAs were 30.9 percent compared with 18.2 percent, respectively. Similar are the results when comparison is extended to other stressed sectors. Thus, when granularly analysed, relatively, performance of PSBs is not inferior to that of PVBs, as is generally being highlighted in media. The issue is that banks with exposure in troubled sectors, then record SAs, irrespective of management/ownership. The sectors in which SAs are large are agriculture (8 per cent) micro industry (12 per cent), small industry (18 per cent), medium industry (31 per cent) and large industry (23 percent). In contrast, ratio of SAs in priority sector are low.

Section III: Case Study of Tractors

In general, the cause of rising SAs could be many and include genuine business reasons like sudden slow-down in the economy – domestic and global, aggressive policies pursued by other countries, and natural calamities. However, there can be major differences in evaluation, monitoring and recovery of loans. This difference in approach is demonstrated clearly in tractor industry.

In tractor financing, at present, according to industry sources, major players are private sector banks and NBFCs (60 percent) while the share of PSBs has shrunk to 10 percent from nearly 50 percent a few years ago. Private financial institutions, which are in the forefront of tractor financing, are HDFC, Kotak Mahindra, and ICICI; and Mahindra & Mahindra, L&T, Tata Capital, and Cholamandalam. Their NPAs are negligible. The rate of interest ranges between 12 per cent and 20 per cent for such loans which are generally less than 4 years and of amounts less than Rs. 4 lakhs. The instalments are made on mutual agreement, either on monthly or crop pattern basis and are collected by agents from the homes of the borrowers, against receipts delivered through hand held devices. The employees of the lending institutions are present in the premises of tractor dealers and offer a commission of 1 per cent as an incentive to facilitate loan for the company. The KYC norms are generally very simple but for security purposes, three blank cheques on returnable basis and two references are provided by the borrower. The loan is extended after extensive field inspection followed by a telephonic check made by the zonal or regional office. Each of the private sector lender has a
risk control unit and there is also a third party review which randomly checks for the credentials of the borrower. The maximum amount of loan is 75 per cent of the value of tractor to ensure that the borrower has monetary stake in purchase. Despite the elaborate arrangement, the loan is sanctioned within three working days. The tractor is hypothecated and the RC book is stamped. The recovery procedure is focused and sometimes recovery amount is enhanced, especially around harvest time.

In the case of PSBs, the situation is in sharp contrast. They strictly follow KYC norms and the borrower has to visit branch office of the bank a number of times to avail the loan. The rate of interest is lower than private sector and ranges between 10 and 15 percent, period of loan is higher and ranges between 7 to 9 years, and amount of instalments is lower and generally monthly. In most cases, the cost of commission offered to the employee of the lending institution ranges from 5 to 7 per cent of value of loan. The process is slow and takes a few weeks for the loan to be realized. In general, PSBs demand hypothecation of 6 to 8 acres of land before extending the loan. In some cases, same land gets hypothecated multiple times and the value of same land for hypothecation gets priced differently at Rs. 1 lakh and sometimes at Rs. 50,000 per acre, illustratively. There have been anecdotes in PSBs, where the loan was collected from the bank but not the tractor from the agency. The verification process of the loan application and repayment capability is obviously not robust and neither the recovery plan; after the loan is dispensed there is no follow up by PSBs and no strict recovery regime. Unlike private sector, PSBs are reluctant to repossess the tractor, many times because of political reasons.

Section IV: Other Factors for rising Stressed Assets.

There are other factors too and there would be a need to address the attitudinal problem in PSBs to address the issue of rising NPAs. The PSBs are different in ownership and obviously will follow different strategy to extend finance and recover loans but the difference in approach is stark and impacting commercial performance. Therefore, there is an urgent need to improve borrower screening, credit appraisal, post-disbursement supervision, and credit monitoring in PSBs. In the private sector and foreign banks, lending and recovery are interlinked with the focus on recovery as end-product while in the public sector this focus is lacking. May be, strategy on ensuring recovery of loans, probably requires a different approach for specific economic activity and industry, and region.
In India, it needs to be recognized that banking facilities have long been misused, including politically. Illustratively, the tradition of loan melas prevalent in 70s and 80, are still fresh in the memory of many borrowers, rural or urban, or small and big industrialists. Loans from PSBs, due to government ownership, are generally considered as grants by many in agriculture and industry, alike. Further, long list of pending cases in debt recovery tribunals (DRTs) and courts, due to well-known delays in judicial system, does not help in encouraging bankers to take defaulters to DRTs or courts for settlements of dues – in fact, borrowers and defaulters, are emboldened in non-repayments of loans.

There are governance issues too. The selection of the chairperson of a PSB is a serious issue as large amounts of public money are involved as also public trust as PSBs account for nearly seventy percent of banking assets. Public sector ownership implies that tax payers are the owners of the bank. Therefore, the selection process has to be very rigorous. The issue was recently examined by a well-represented Committee chaired by P J Nayak (2014). The Committee observed that the process of selecting the top management of banks, including the chairperson needs to be professionalized as candidates were interviewed, sometimes, for less than five minutes before decision was made. Again, according to the Nayak Committee, there was no search committee stipulated for the top positions of PSBs. The shortlisting occurs on the basis of demographics associated with cadre of executive directors and general managers in all PSBs. In recent years, with expansion of banking activity, and lack of man power planning, there is shortage of potential candidates, eligible for the chairpersonship of PSBs. In 2015, an attempt was made to draft and recruit seniors officials from private sector into PSBs but only in a limited number amidst some opposition to the concept. Therefore, compromises are made in terms of experience at senior levels in promoting individuals to higher positions.

The policy as to on what basis is a particular bank assigned to a specific candidate as a chairperson has also to be transparently delineated. In many instances, a cadre officer of a bank with extensive network of branches in North India takes over as chairperson of a bank with extensive branch network in South. Consequently, as banking is closely connected with cultural values and social norms, there is friction and difference of opinion between the chairman’s secretariat and the banking staff. Similar is the difference in working culture between large and small banks. Such a chairperson cannot lead a bank to successfully robust balance sheet.
The policy environment, and government policy initiatives also impact rising level of SAs. The laws related to acquiring of land, issues related to mining in recent years and policy paralysis also directly impact asset quality in banks.

Banking activity cannot be divorced from the society and therefore there is a larger issue of declining ethical standards in banking, not only in India but across the world. This greedy and unethical behaviour was illustrated in repealing in 1999 of the Glass-Steagall Act of 1933.

Section V: Borrower Misconduct Issues – case study of PPP infrastructure projects

Public infrastructure is imperative to a nation's economic growth, public welfare and improvement in quality of life. Building public infrastructure requires substantial upfront capital, which is invariably financed from various sources like public sector (banks and government) and private sector – usually in a ‘Public Private Partnership’ (PPP) delivery model.

In India, public sector of the partnership usually comprises a procuring authority (PA) and PSBs (i.e., sometimes PVBs may also be part of the lenders’ consortium). The private sector comprises the private player(s) who commit to bring in common equity. The project entity is usually a special purpose vehicle (concessionaire). Globally, PPP delivery model has developed during last two decades – India has rather limited practical and legal experience with this model, and has had a mixed success.

Large value loans of many PSBs to PPP infrastructure assets have been classified as SAs. The analyses of various SAs relating to PPP infrastructure projects show that numerous concessionaires misused the PPP delivery model to borrow large funds from the PSBs, and diverted these funds to their other businesses or siphoned them off (to both India and overseas), while themselves bringing in little or no equity which was committed. This is alarming because the original intent of the PPP delivery model was to harness funds (and expertise) from private sector, but the model has been misused by some private players to the detriment of public.

This rampant pilfering of public funds in some PPP projects highlights gaps in the existing legal, policy, and/or regulatory framework, as well as point toward the need to revisit the
provisions of model concession agreements (MCA). Also, PSBs hesitate to restructure such borrowers due to legal and operational challenges associated with removal of errant promoters, as well as operating the business of the borrower (as the banks may not have the expertise to run the business).

The gaps and issues need to be immediately addressed before financing new public infrastructure projects through the PPP delivery model. The key issues that cause the bank loans to become stressed, specifically in the public infrastructure domain are summarised below.

1 **Fake equity of the concessionaire through diversion and round-tripping**

Chart 1 depicts modus operandi deployed by some concessionaires to create fake equity. The concessionaire usually appoints an engineering-procure-construction subcontractor (EPC contractor), who is usually part of same promoter group. Some other suppliers of concessionaire may also belong to same promoter group.
Chart 1: The Modus Operandi

Legend: EPC Contractor: Engineering-procure-construction subcontractor; VGF = viability gap funding

The grant and loan funds received from the PA or PSBs are used to pay further mobilization advances or interim payments to related-party EPC Contractor and other related party suppliers, who would then round-trip the same back to concessionaire and show them as promoter’s required “equity” into the Concessionaire. In certain cases, phantom payables are created by obtaining mis-invoiced or over-invoiced goods and services at inflated prices, or for fictitious items. These phantom payables are then converted into equity of the promoter group entities, thereby creating equity of the concessionaire using fake bills.

The post-disbursal loan monitoring and supervision by PSBs of the concessionaire’s end use of funds is often inadequate or non-existent to either identify the real source of promoter’s equity, or prevent fictitious claims (of promoter group entities) from getting converted to concessionaire’s equity.
2 Inflated project construction costs to fund the project only with public funds

Some Concessionaires increase the total project cost (TPC) by two or three times the original TPC (which is prepared by the Procuring authority (PA) at the time of bidding) to obtain higher grant and debt from PA/PSBs. This allows the Concessionaire to practically fund the entire construction cost with public funds, while itself contributing zero or negative equity (i.e., taking out the funds of PA/PSBs through diversion or unusually high margin on work performed by the promoter group entities).

The table below exemplifies how concessionaire may submit increased estimate of the Total Project Cost (TPC) to seek additional borrowings from the banks. The example shows that two cost estimates, after the original TPC prepared by the PA, were prepared and submitted to banks.

Table 2: Progressively higher TPC is estimated to borrow more funds

<table>
<thead>
<tr>
<th>Source of funding</th>
<th>Estimated TPC of the PA (used for bidding and VGF)</th>
<th>Estimated TPC of the concessionaire at financial close (1 to 2 years after the TPC of the PA)</th>
<th>Revised estimated TPC of the concessionaire (usually 2 to 3 years after the financial close)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Concessionaire’s Equity</td>
<td>100</td>
<td>362.5</td>
<td>590</td>
</tr>
<tr>
<td>Debt - PSBs loans (assumed 65% of the TPC)</td>
<td>650</td>
<td>1,138</td>
<td>1,560</td>
</tr>
<tr>
<td>Grant – from the PA</td>
<td>250</td>
<td>250</td>
<td>250</td>
</tr>
<tr>
<td><strong>Total project cost (TPC)</strong></td>
<td><strong>1,000</strong></td>
<td><strong>1,750</strong></td>
<td><strong>2,400</strong></td>
</tr>
<tr>
<td><strong>Total public funds (PA + PSBs)</strong></td>
<td><strong>900</strong></td>
<td><strong>1,388</strong></td>
<td><strong>1,810</strong></td>
</tr>
</tbody>
</table>

PA: Procuring Authority; PSBs: Public Sector Bank; TPC: Total Project Cost; VGF: Viability Gap Funding

At financial close, the concessionaire claims that the estimated TPC is higher than was estimated by the PA. In the above example, if the actual construction cost is less than INR 1,388 (or INR 1,810 for Revised estimated TPC), but the concessionaire is successful in

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3 Note 1: The PSBs consider the grant by the PA as “equity” to calculate the debt-equity ratio (DER). Also, PSBs usually finance 65 to 70 percent of the TPC, which results in DER of 2x debt to 1 x equity

4 The PA limited its exposure to the original TPC and does not give additional grants.
showing to the banks that the estimated TPC is INR 1,750 (or Revised estimated TPC is INR 2,400), the entire project can be constructed using the public sector funds (PSBs and PA). Hence, the concessionaire does not have to bring in any equity of its own.

When required by the PSBs to evidence and substantiate the increased TPC, the concessionaire usually submits documents (e.g., contracts/bills/cost estimates, etc.) obtained either from promoter group entities or from ‘accommodation entry operators’. These documents window dress the construction costs, and show them substantially higher. The PAs/PSBs do not critically verify the revised construction cost estimates. While, the PAs usually refuse to allow additional grant based on concessionaire’s estimated TPC (or revised estimated TPC), the entire burden usually falls on the PSBs to finance increased TPC. PSBs justify the increased loan amounts by getting a techno-economic valuation (TEV) report which shows that the future revenues (from tolls/tariffs) will be adequate to repay the loan equated monthly instalments (EMI) and service the interest costs. However, anecdotal evidence has shown that the TEVs have a huge optimism bias built into them by overestimating the tariffs (e.g., higher traffic projections) and rarely contain reliable revenue numbers.

3 Conversion of secured funds of the PSBs into unsecured assets

While the funds lent by PSBs to concessionaires are secured assets (usually kept in escrow account), they are disbursed to related parties (EPC contractor and/or suppliers) as unsecured loans or inter-corporate deposits (ICDs) by the concessionaires.

When the concessionaire defaults, PSBs do not have a legal recourse to enforce their security interest (e.g., under DRT Act, SARFAESI Act) against other promoter group entities and the realisation of such monies advanced to its related parties is extremely difficult. Such other promoter group entities may also have stashed their funds in foreign countries; or will have other creditors (secured or unsecured) whose claim will rank above the unsecured claims of the PSBs to the concessionaire.

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5 DRT Act refers to the Recovery of Debt Due to Banks and Financial Institutions Act, 1993. Section 28 – ‘Other modes of recovery’ empowers the bank’s recovery officers to recover assets from third parties, but such legal powers are easily frustrated through fraudulent conveyances (e.g., transfer to legal entities, conversion and disposition, transfers to family members or benami transactions).
Another legal issue that the PSBs face is in the interpretation of the promoter group. Sometimes, the loan funds are diverted to legal entities which are owned by the spouse, close or distant relatives of the promoter, or of same promoter. Even when there is evidence to show that borrowed funds were sent to legal entities owned by relatives, the PSBs face substantial legal hurdles to access funds (or property that may have been bought using such funds).

4 Lack of personal and corporate guarantees from the promoter group

Sometimes the PSBs have not taken personal guarantees of the promoters or from holding and other group entities of the concessionaires. This makes it challenging to seek legal recourse against other promoter group entities, as well as personal assets of the promoters.

5 Right to audit and inspection over other promoter group entities

Many loan agreements do not contain legal rights to access the books and records of the related parties even if they have received significant funds from the concessionaire. These rights are essential to determine the end use of funds, as well as to gather evidence of diversion/siphoning-off/round tripping of funds that may be essential to determine whether promoter group is a wilful defaulter.

6 Foreign minority shareholder

Some concessionaires and promoter groups’ structure use a foreign entity, which is usually shown to hold some minority equity stake in the concessionaire. Often times, the foreign entity is a passive entity (usually shell company or entities), and brings in no equity or technical expertise during the construction phase. However, once the concession period starts, and the revenues from tolls start to be received, this entity becomes entitled to proportionate share in the profits of the concessionaire. This way, the concessionaires/promoter groups find a legally acceptable way to remit their moneys abroad and create foreign wealth.

Non-performing assets

The diversion of funds to other businesses, and lack of equity funds significantly delay project implementation, causing project costs to rise further and more importantly, significantly delaying project revenues (e.g., toll when project is put to use). The lack of revenues/cash flows lead to inability to service interest costs and EMI. Many times, the
concessionaires are unable to bring in diverted/ siphoned-off funds, leading to loan defaults and ultimately SAs.

**Section IV: Conclusion and Recommendations**

In recent years, there has been a substantial rise in stressed assets, mainly in PSBs. However, this should not be too worrisome, as in the past, India has a track record of recovering from difficult asset position. Further, in many other countries because of global slow down similar situation has emerged. Rather, India should take this opportunity to introspect and analyse the causes of such deterioration in asset quality of banks and undertake remedial measures.

In addition to global factors, there could be many more factors like deficiencies in procedures and practices followed in some PSBs compared to others. In addition, there could be factors like deficiencies in governance, political interferences and ethical issues like mal–intentions as well as misconduct by the borrowers, unfortunately with connivance with bank staff. This is stark in cases of PPP infrastructure projects where amounts are significantly large. Consequently, diversion and siphoning-off of borrowed funds cause huge losses to the nation – both by causing financial losses to the PSBs, as well as delaying the project implementation and resulting public welfare and quality of life.

**General Recommendations**

1. A special cell, on Mission Mode, may be set up in the government, preferably within Department of Financial Services, Ministry of Finance, to swiftly and expertly deal with all NPAs. This cell should have banking, legal and financial experts to investigate the NPAs, as well as decide on appropriate legal remedies under the loan agreements, SARFAESI Act, DRT Act, RBI guidelines, Companies Act, etc. This cell will also provide guidance and support to bank staff who are generally inexperienced in legal and procedural aspects of various statutory options available to them.

2. A Standing Committee on Frauds and Stressed Assets could also be helpful in immediately addressing issues. The Standing Committee should have members from the regulators, bankers, intelligence agencies, rating agencies, and auditing and consulting firms. The rating agencies, and auditing and consulting firms have special and granular information which regulators may not have.
To ensure rigorous and regular monitoring and evaluation, all cases of SAs above Rs. 100 crore should automatically come under jurisdiction of the Mission Mode and Standing Committee.

The need is to undertake extensive research on why SAs are rising in select PSBs. In a diverse country like India, with different climatic zones, cultures and occupational structures, banking habits differ. Therefore, a segmented and focused study on different banks and regions is probably necessary. Illustratively, literacy levels and general attitude helps to determine the choice between saving and term deposits. In banks dominating in north India, generally, the level of savings accounts vis-à-vis term deposits are generally large as compared to the trend in South India. Similarly, banks which generally have a wider retail base have not recorded higher SAs unlike banks which have significant exposure to corporates. But building a retail base requires a different skill set than extending large loans to select corporates.

The onus of rising SAs has also to be shared by other players associated with decision making in financial institutions like auditors, rating agencies, valuation experts for the TEV reports, etc. It would be useful to study the qualifications and expertise of the valuers that are on the panels of commercial banks. The quality of concurrent audits, statutory audits, stock audits, etc. should be examined.

To address governance issues, selection of personnel for top management needs to be given utmost importance. The potential candidate for such positions should be able to convince a panel of experts, drawn from different fields, about the knowledge of the bigger picture in which the banking sector is expected to perform and offer a game plan to position the PSB to face higher competition. If the PSBs have to compete successfully with foreign and private banks, the chairperson has to be equally competitive, with a clear vision and mission. In fact, the expertise required to manage the bank, are different from operational banking. To develop managerial skills, either the employee gathers expertise and maturity by working for years as ED or else, supplemented by extensive training. Only then can an individual be expected to effectively lead the PSBs through challenging competition from private and foreign banks. To search for suitable candidates, in globally competing environment, it may be useful to open selection process to willing senior
officials from private and foreign banks. Such officials could bring dynamism to the working of PSBs. In any case, most of the senior officials in private sector banking institutions at present started their careers in public sector banks.

7 To attract the best talent available in the banking industry to serve Top management positions in PSBs, four things need to be addressed. First, the tenure of the Chairperson or managing director which according to the Nayak Committee is sometimes only about 18 to 24 month. The government could consider a longer tenure of 5 years, based on strict performance evaluation criteria. Second, the retirement age in public sector banks is 60 years. To harvest the experience of capable persons who have successfully emerged through the system, the government could consider extending the age limit for senior level managers, as already extended to 70 years for private sector banks. Probably, a good example is the graduated retirement age model successfully followed in the defence forces where generally retirement age is 54 years upto the rank of Colonel and then increases gradually to 60 years for the General. Third, remuneration has to be commensurate with the position and relative to those in similar institutions in private sector. Finally, once, international standards of selection are met, the government should set steep performance benchmarks and undertake strict performance appraisals. In the evaluation process, existing Indian Banks Association can play an important role in providing peer reviews to the evaluating authority.

8 There is also a need to study whether there is increasing pressure on bank staff to lend recklessly for short term gains without considering long-term interests? Is it an incentive structure, lax governance, absence of regulatory architecture or weak enforcement? Ethics in banking are not a soft subject any more, as it bears influence on financial stability, economic growth, and jobs. Therefore, commercial banks have to ensure that there are regular, probably annual, training sessions on ethics, especially for its middle and senior level employees.

9 Special Committees on Large Value Frauds (SCLVF)s and Chief Vigilance Officers (CVOs) at PSBs. The role of SCLVF)s need to be examined as they mostly focus on post-facto investigation of frauds rather than preventive vigilance. The skills and technical expertise of CVOs may also be examined as most CVOs have banking background and knowledge but not the investigative and law enforcement experience.
**PPP-related Recommendations for existing cases**

10 In case of existing NPAs in PPP projects, the PSBs should get forensic audits on PPP projects to verify if (a) promoters had brought in their equity, and (b) public funds were diverted or siphoned off. Appropriate legal actions could be taken against the errant promoters that include cure-rights, step-in rights, declaring them wilful defaulters, identifying and attaching properties both in India and abroad to recover bank funds. If the projects were funded only by public funds, the promoters should lose their right to collect tariffs from projects, and any profits already made should be disgorged.

11 The forensic audits should be well scoped, and be provided full cooperation by the PSBs. Historically, certain PSBs launched forensic audits, but the other consortium members provided limited or no cooperation. The PSBs also did not provide the bank statements/financial info about promoter group entities (e.g., EPC contractor, other SPVs, parent company, etc.) that were available with them. Also, the promoter group entities did not cooperate with the PSB’s forensic audits to allow access to their books, records and staff. These impediments and limitations on access to information leads to failure of forensic audits. When promoter group entities do not cooperate with forensic audits, appropriate law enforcement agencies can be involved (e.g., SFIO, CBI, etc.) to gain access to relevant books, records and borrower’s staff.

12 Funds diverted to foreign jurisdictions through mis-invoicing can be traced and frozen with the involvement of appropriate channels (e.g., Stolen Assets Recovery – StAR, asset recovery consultants, etc.). Many PSBs staff are not aware that there may be certain legal options available to nab the absconding borrowers and confiscate their foreign properties. Although this is a prolonged and costly task, it can be used in certain large value defaults. This will also send a deterrent message that no matter where the errant borrowers hide their wealth, it could be confiscated.

**Recommendations for future PPP projects**

Some key changes that the government/ PAs and PSBs may make in relevant legal framework including model concession agreements and lenders agreements, include:
13 Require certification from the concessionaire to provide details of the end use of borrowed funds. If the amount is above certain threshold (say Rs. 50 crore), a chartered accountant’s certificate may be required. Any misrepresentation in this certification by the borrower or a chartered accountant may be made a fraudulent practice under the criminal law. The Chartered Accountants should also be held responsible for the error or misrepresentation in their reports/certificates.

14 Diversion/siphoning-off/round tripping of funds – while RBI’s guidelines⁶ require that the borrowers to be classified as wilful defaulters when they divert or siphon off borrowed funds, the PSBs do not have the tools to timely identify diversion/siphoning off, gather sufficient evidence and take strict action. The credit monitoring of the PSBs fails to go into sufficient depth to identify diversion/siphoning, or if such issues are identified sometimes, the banks do not take sufficiently objective and strict action. Therefore, it is recommended that monitoring be adequately detailed to identify such issues, and culture in PSBs be strengthened to take immediate action who divert funds. Further, mere threat of getting declared as a wilful defaulter does not send a sufficiently strong deterrent message, and the government should amending laws that clearly made diversion and siphoning a criminal offences.⁷

15 Strict supervision and monitoring over the disbursement of funds from escrow account. Prevent free transfer of funds to related companies for unjustified mobilisation advances, over-invoicing/for inexistdent goods and services. The PSBs may use monitoring agent to control the disbursements to related parties above certain thresholds, as well as to prevent entering into contracts with related parties at non-arm’s length prices. The Hawthorne effect will help in reducing the diversion of funds from the escrow account.

16 The PSBs loan agreement could seek a “golden share” which provides PSBs with control under the Companies Act 2013 over the SPV in the event of any stated default.

17 Guarantees from the promoters and group entities be sought, at least to the extent of cumulative funds transferred to them by the concessionaire (for example, in some other

⁶DBOD No. DL.BC.16/20.16.003/2009-10 dated 1 July 2009
⁷Currently, The Indian Penal Code’s section 403 – Dishonest misappropriation of property (which applies only to moveable property) and section 415 – Cheating may be used. However, these sections are unclear as far as confidently bringing in cases of diversion or siphoning off funds under these sections.
countries, lenders also have direct contracts with EPC contractors in PPP delivery models. This is important because the borrower (i.e., the concessionaire) is a separate legal entity, and PSBs legal rights and recourse is restricted only to this entity and not to beneficial owners behind the entity (with whom there is no privity of contract, or guarantees). As a result, PSBs face numerous legal hurdles when piercing the corporate veil to access the property of the promoter group entities who may have taken PSBs funds out of the concessionaire. Currently, there is no specific law to lift the corporate veil and court’s intervention is required on a case to case basis to access the books, records and property of promoters and their group entities.

18 Seeking audit and inspection of the books and records of related/promoter group entities of the borrowers who received funds from concessionaire. PSBs should have legal rights and recourse to determine the end use of funds, and if they were diverted to other uses, or round tripped to be brought in as fake equity. Further, any obstruction or non-cooperation by the promoter group to audit and inspect the records should also be made a criminal offence.

19 Independently audit the cost increases (above certain thresholds) claimed by the concessionaire, particularly if significant part of the work/EPC contract is subcontracted to promoter group entities. These should include using independent engineering and forensic experts to review the cost increases above certain thresholds.

Finally, to conclude, the current situation has raised an important issue which needs extensive research in addressing the issue of rising NPAs in PSBs which are different in ownership and obviously follow different strategy to finance and recover loans from private banks. In addition to better training of the staff, standardization of norms, improvement in credit appraisal, post-disbursement supervision, credit monitoring there is need to put emphasize and improve recovery. The national institutions dedicated to research on banking like National Institute of Bank Management and Indian Bankers Association, could probably play an important role in such focused analysis of the malady to ensure higher recovery now and lower NPAs in future. The PPP delivery model has worked in many other countries and is imperative to fund the capital intensive infrastructure projects. However, the gaps in legal, policy and regulatory framework be addressed on priority before further loss to the national exchequer.
References


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