

## Probability of Default and NPAs

Growth across all sectors of the economy is desirable to stimulate the impending precedence of tight liquidity and credit impediments. We are making this representation to highlight the urgency to evolve a new measure other than the 90 day rule for declaring non repaying credit asset as an NPA. This representation from small businesses comes in wake of the move to focus the plight of these businesses that have been contributing 40% of the GDP and are presently under distress not only due to slowing economic conditions, tight liquidity but also due to the 90 day rule. The 90 day rule which has declared most of the small businesses or SMEs as NPA should note that, in spite of the undesirable economic conditions, are trying to match their assets and liabilities best as possible and this plea has been further discussed deeply in this representation.

Creation of alternate jurisdictions for dumping of negative assets would act as a temporary arrangement in absence of an appropriate and permanent solution so as to inoculate the banking system from the very cause which gives rise to an NPA. Periodic cleaning of bad loans can be treated as a process for keeping the banking system healthy without prejudice to the prevalent conditions of NPAs due to which the same has been proposed. In order to find a permanent solution to the NPA distress, one needs to understand and absorb the requirements of the economy which support the banking industry in reality. In precedence of the present scenario it should be noted that the previous NDA regime had implemented a system of freezing of the interest and one time settlement of the principle between the banker and the obligor which had boosted not only growth but also prevented the hassles of NPA for both the entity. A non recurrence of bad debt also was observed in this type of settlement which helped cleansing of the NPA distress right from the root.

In a situation of zero credit demand it would be unviable to have the massive credit infrastructure in India in the form of different types of institutions right from money lending to International banking agencies, hence underlying norms for credit recovery need to be reviewed and reset as per economic scenario requirement and its urgency to be treated with priority.

There are two issues which the banking industry especially the public sector needs to take care of, the cleansing of the balance sheets on one hand and prohibition of future assets turning bad on the other. It has been suggested through various forums that in order to cleanse stressed balance sheets a separate entity needs to be developed to load the stressed assets which would be later discounted and sold as stress bonds to private players. However, it is very pertinent to note that the, factor which terms a credit asset as bad is the duration i.e the 90 day period. This principle of terming a loan asset bad needs urgent review to test its efficacy in the present global economic conditions. The very fact which rules the this principle ghastly, is that the period for receipt of dues against the delivery of goods itself is 90 days which is used as an asset liability match by many of the creditors while working out their working capital requirement. Due to unavoidable prevalent systemic global economic issues there has been a lag in receipt of dues in many economic sectors, these issues along with others such as inherent delays in project clearances like environment license, land acquisitions etc have put projects in a back log and non earning of revenue, inspite of promising futures they would deliver for the Indian economy. Such relevant bottlenecks have turned good business propositions rated excellent by authorities like CIBIL into black holes by the 90 day NPA rule. It is also a very evident fact that our Government has been implementing and accepting international standards as it is without consideration of the same to the local need and demand or after having consultation with the very people who are liable to be affected by it. Government of most of the countries especially the developed countries have had better representation at the International law making benches in the banking industry and have not made International practices mandatory in their own countries without inspecting their viability thoroughly, some European countries have not even accepted the 90 day NPA rule as a measure to detect bankruptcy or NPA status.

The 90 day rule proposed as per international standards no doubt is an excellent measure to safeguard the banking industry against a probable default however, research indicates that huge defaults have been impeded by large business houses rather than small time businesses. The 90 day rule has shooted trouble for the small businesses who have limited recourse to funds and probably no political recommendations to summon their

pleas. In a situation such as this we strongly recommend that a continuous credit risk monitoring process needs to be built so as to assess the creditor for his valid pleas for nonpayment of banking liabilities and inept decisions such as the 90 day rule should be avoided grading the loan asset as an NPA. This would prove handy even for smooth decision making for the applicable banking authority for eg the branch manager or the chief loan disbursement manager to rely upon to judge the credibility of the creditor thus removing bias while granting relief to an eligible creditor seeking an extension for payment towards his liabilities.

The internal system should be based on entity like the probability of default which encompasses all the conditions measured, and input for calculation of the same so as to term an asset a NPA. The PD is calculated at the phase of inception to determine the credit risk involved while initiating the release of credit. This measure needs to be continuously calculated through the duration of the obligation, as the same factors from the obligor's end parameters like inadequate cash flow to service debt, declining revenues or operating margins, high leverage, declining or marginal liquidity, the inability to successfully implement a business plan, revenue growth (wholesale), number of times delinquent in the past six months (retail) and macroeconomic information like house price indices, unemployment, GDP growth rates, economic environment and the degree to which it affects the obligor etc.

Thus, the information available to estimate PD can be divided into two broad categories obligor specific information and macroeconomic information. This proposition would be critical sensor to probable realistic default. This parameter can be emboldened by linking the creditors loan obligations at the various banking outlets with a single ID so that the continuous PD is strong indication of a probable default. The 90 day rule can also be worked in coordination with this parameter so that there is a cross referencing. The proposed frequency for PD calculation should be 2months from the point of inception of such a lending.

This proposition spells 90% confidence before terming a loan asset bad ready to be dumped to a separate jurisdiction thus will not only save operational procedures but will bring relief to the SME. On the other hand it should be noted that in case of medical emergency like heart attack a patient is treated and undergoes medical procedures to save him from possible death, but the ill is that in case of business operation, the 90 day NPA rule has created an illusion that the business is dead on defaulting payment for 3 months and needs to be directly sent to the morgue instead of undergoing a probable remedial measure.