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Tackling the Impact of COVID-19 on the
Indian Banking Systems based on an
Analysis of Non-Performing Assets

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Abstract

The Indian Banking Sector has had its ups and downs in the past decade. This paper tries to understand the history of the sector in terms of Non-Performing Assets (NPAs) followed by the establishment of how the sector is going to react to the impact of COVID - 19. There is an analysis of the sectors which are worst hit by the pandemic and have high NPA ratios thus, having an unstable financial background. The policy measures recommended focus on improving liquidity and aggregate demand in the sectors which have been affected to great lengths by the pandemic. This paper recommends ways to prevent the banking sector from deterioration in the foreseeable future and weather the storm created by the pandemic with minimum negative aftermath.

Keywords: *Non-performing Assets, Covid 19, Liquidity, Asset Quality*

1.0 Introduction

The Indian financial system is an organized pool of assets under the umbrella of the Reserve Bank of India. The biggest threat to the financial system is the existence of non-performing assets. If the interest or instalment amount is overdue on a loan account for more than 90 days, then it is termed as a Non-Performing Asset. NPAs are the reason why countless economies go into recession. It is a slippery slope as the subsequent increase corresponds to an increase in loan payment defaults and later the collapse of the whole banking system.

Around 2005, the Indian Scheduled Commercial Banks (SCBs) experienced rapid growth in gross advances which was improving their financial stability. But very soon the system took a turn for the worse. The financial crisis of 2007-08 impacted the whole world and India was no exception. The growth in Gross Non-Performing Assets (GNPA) in the Indian financial system intensified around that period. The Indian companies started defaulting and this increased the proportion of stressed assets in the system. The situation intensified till 2015.

In 2018, the situation started improving due to certain policy changes. There was a reduction in the incremental NPAs and thus, the GNPA as a percentage of Gross Advances started declining. Just as the GNPA percentage was improving, the world was hit by a pandemic. The lockdown of the economy due to COVID-19 has created a severe liquidity crisis for the companies. Due to a decline in the production as well as demand throughout the economy, several sectors like power, steel, infrastructure and agriculture faced damages and loss.

Thus, having understood the history and the stability of the Indian financial system and the impact of new challenges posed by the pandemic, this paper tries to evaluate the future of the financial sector of India by diving deep into 4 different phases of the intensity of the non-performing asset situation, how it evolved and improved with the introduction of different policy changes. This paper will also include a detailed inspection of the infrastructure, power, steel and agricultural sector which have been impacted severely by the pandemic and will provide suggestions to rectify the situation.

2.0 History of the Non-Performing Assets

2.1 Phase 1 (2005-2013)

India was experiencing high GDP growth around 2005-06. The GDP growth rate was 7.92% and 8.06% in 2005 and 2006 respectively. (GDP Growth (Annual %) - India | Data, n.d.). This growth was fuelled by a variety of projects across different sectors in the economy. To facilitate this growth, banks started lending over-optimistically. This led to a rapid increase in the growth rate of Gross Advances.

Year	Growth Rate of Gross Advances
2005	31%
2006	31%
2007	28.5%

(Lokare, 2014)

While the Indian economy was flourishing, the United States got slammed by the financial crisis of 2008. The housing market collapsed because a huge amount of assets got defaulted. There was a significant rise in the demand generation in the economy which impacted global supply chains. In 2008, Indian exports to the USA were US\$ 21,407 million. (World Bank, 2008). Subsequently, the crisis impacted Indian growth severely. Due to disturbance in global supply chains, there was a reduction in orders. Thus, the corporates had a severe liquidity crisis and subsequently, there was a sharp increase in the gross NPAs. The growth of NPAs in 2008 was 11.4%. (Lokare, 2014).

For the Indian economy to start recovering from the crisis, there was an unsubstantiated push by the government in the form of a stimulus across different sectors in the economy. The private sector capitalized on the situation and started taking up projects. This led to a sharp

rise in the GDP growth of India from 3.087% in 2008 to 7.862% in 2009 and 8.498% in 2010 (GDP Growth (Annual %) - India | Data, n.d.). Over time, the corporates started taking loans to kickstart their projects, the banks continued their over-optimistic lending without conducting proper due diligence. This increase in gross advances was good for the growth of the financial sector at that point but what remained under the cover was the consequences of lending over-optimistically. The lack of rigid supervision by the Reserve Bank of India allowed the situation to prevail. Under this phase, there was constant but linear growth in GNPs.

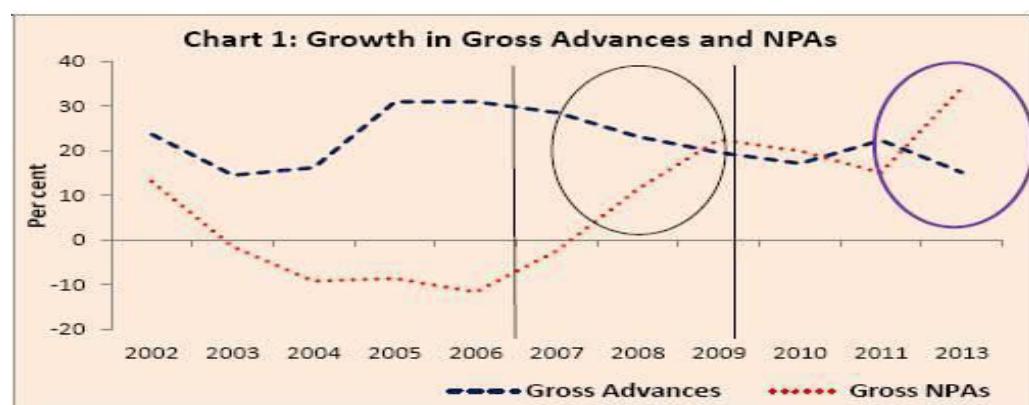
Year	GNPAs to gross advances
2010-11	2.4%
2011-12	2.9%
2012-13	3.2%

(Reserve Bank of India, 2018)

This was a period when the banks were experiencing profitability and stability. They were completely ignorant of the exponential growth in GNPs to gross advances that were waiting for them in the next phase.

2.2 Phase 2 (2013-2017)

Under this phase, the effect of lending without due diligence started reflecting in the financial system. As a large amount of the gross advances was lent to firms with weak balance sheets, the number of defaults started rising. Many projects were not able to meet the standards and eventually could not pay back their obligations. These defaults started a cycle that developed into the twin balance sheet problem which refers to a situation where the Indian Companies were not able to pay back their liabilities and the SCBs were not able to collect the value of their assets.



(Lokare, 2014)

The inception of this phase saw the growth in GNPsAs superseding the growth of Gross Advances.

Year	GNPAs to Gross Advance	GNPAs to Total Assets
2013-14	3.8%	1.3%
2014-15	4.3%	1.5%
2015-16	7.5%	2.7%
2016-17	9.3%	3.1%

(Gross and Net NPAs of Scheduled Commercial Banks Bank Group-Wise, 2018)

The proportion of GNPsAs increased exponentially in this period.

2.2.1 How do NPAs affect the profitability and the stability of the banks?

When an asset becomes a non-performing asset, the return of the principal amount becomes questionable and the interest income that should be generated by the asset halts. In practice, more often than not, less than 50% of the asset value is monetized. A major part of SCB's advances goes to Non-Banking Financial Companies. NBFCs lend and make investments but they cannot accept demand deposits thus, they require banks for capital.

Asset Quality of NBFCs

Year	Gross NPAs
2014	2.6%
2015	4.1%
2016	4.5%
2017	6.1%

(Non-Banking Financial Institutions, n.d.)

The asset quality of the NBFCs also declined during this phase and thus, the investments made by banks were not providing adequate returns or stability to them. Due to the above factors, the financial strength of the SCBs was declining and a bubble of stressed assets was expanding in the economy. The situation was mirroring the conditions which lead to the financial crisis of 2008 in the United States of America. At this point, the Reserve Bank of India along with the Central Government decided to intervene with paradigm policy changes to rectify the situation.

2.2.2 Insolvency and Bankruptcy Code (IBC), 2016

Under the code, when any corporate debtor commits a default, a financial creditor, an operational creditor, or the corporate debtor itself may initiate a corporate insolvency resolution process in respect of such corporate debtor. Once an application is filed, within 14 days the authorities have to ascertain the existence of the default. If the existence of the default is ascertained, the debtor is given a chance to rectify the situation in the next seven days. If the same is not corrected, the process of putting the corporate debtor's company into insolvency and bankruptcy is initiated.

The Corporate Insolvency Resolution Process shall be completed within a period of one hundred and eighty days from the date of admission of the application to initiate such a process. If an application is filed and accepted to extend the duration of such process beyond one hundred and eighty days by such further period as it thinks fit, it should not exceed ninety days. In some cases, where a corporate debtor with assets and income below a level as may be notified by the Central Government is concerned, the corporate insolvency resolution process shall be completed within ninety days from the insolvency commencement date. The corporate insolvency resolution process cannot be completed within ninety days, it may, by order, extend the duration of such process beyond the said period ninety days by such further period, as it thinks fit, but not exceeding forty-five days.

The insolvency process can lead to a couple of outcomes, i.e., liquidation and resolution of the company. Liquidation refers to monetizing the assets of the business. It brings a percentage of the principal back into the system. Resolution refers to bringing the company out of the defaults and rescuing the stressed assets. It helps to re-generate income from those assets. Thus, the implementation of IBC speeds up the process of recovery and ends the cycle of incremental NPAs.

2.2.3 4R's Strategy by the Central Government

4R's strategy refers to the recognition, recapitalising, resolution and reform of the non-performing assets. The Government has implemented a comprehensive 4R's strategy, consisting of recognition of NPAs transparently, resolution and recovery of value from stressed accounts, recapitalization of PSBs, and reforms in PSBs and the wider financial ecosystem for a responsible and clean system. Comprehensive steps have been taken under the 4R's strategy to reduce NPAs of PSBs, including, *inter-alia*, the following:

i. Change in credit culture has been affected with the Insolvency and Bankruptcy Code (IBC) fundamentally changing the creditor-borrower relationship, taking away control of the defaulting company from promoters/owners and debarring wilful defaulters from the resolution process and debarring them from raising funds from the market.

ii. Over the last four financial years, PSBs have been recapitalized to the extent of Rs. 3.12 lakh crore with an infusion of Rs. 2.46 lakh crore by the Government and mobilization of over Rs. 0.66 lakh crore by PSBs themselves enabling PSBs to pursue timely resolution of NPAs. (Press Information Bureau, Delhi, July 19)

iii. Key reforms have been instituted in PSBs as part of the PSBs Reforms Agenda, including the following:

a) Board-approved Loan Policies of PSBs now mandate tying up necessary clearances/approvals and linkages before disbursement, scrutiny of group balance-sheet and ring-fencing of cash flows, non-fund and tail risk appraisal in project financing.

b) The use of third-party data sources for comprehensive due diligence across data sources has been instituted, thus mitigating risk on account of misrepresentation and fraud.

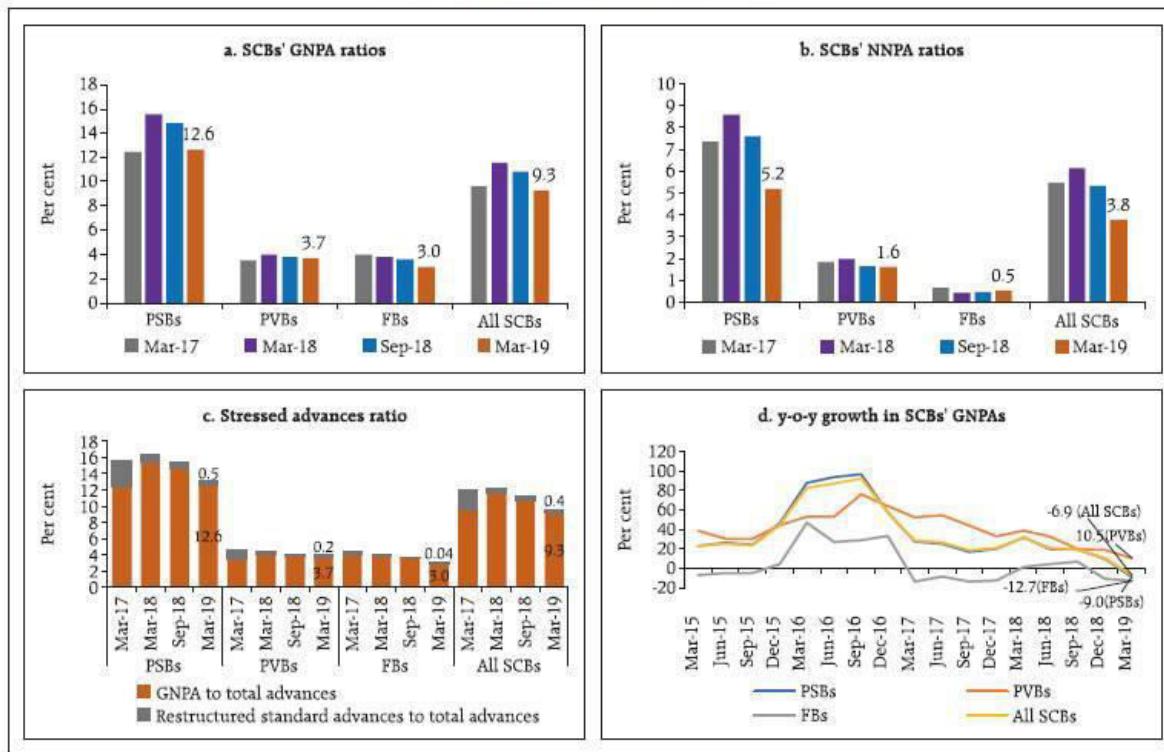
c) Monitoring has been strictly segregated from sanctioning roles in high-value loans and specialized monitoring agencies combining financial and domain knowledge have been deployed for effective monitoring of loans above Rs 250 crore.

d) To ensure timely and better realization in one-time settlements (OTS), online end-to-end OTS platforms have been set up.

2.3 Phase 3 (2018-2019)

The effect of all the above-mentioned policy changes started reflecting in the system in this phase. Since the inception of IBC 2016, 780 companies have gone into liquidation and 190 companies have witnessed resolution. The companies sent for liquidation have assets worth Rs 0.2 lakh crores and the companies sent for resolution rescued assets worth Rs 0.8 lakh crores. 4R's strategy had a great impact on the NPA situation. NPAs of PSBs, after reaching a peak of Rs. 8,95,601 crores as on 31.3.2018 have declined by Rs. 1,06,032 crores to Rs. 7,89,569 crores as on 31.3.2019 (provisional data for the financial year ending March 2019) and PSBs have affected record recovery of Rs. 3,16,479 crores over the last four financial years, including record recovery of Rs. 1,27,987 crores during 2018-19. Systematically after these policy changes, the NPA ratio started improving.

Chart 2.2: Select asset quality indicators (Contd....)



(Financial Institutions: Soundness and Resilience, 2019)

There was a continuous reduction in the quantity and growth of non-performing assets. Due to RBIs rigid supervision, the percentage of restructured loans to gross advances also declined.

The capital to risk-weighted assets ratio (CRAR) of Scheduled Commercial Banks (SCBs) edged down to 14.8% in March 2020 from 15.0% in September 2019 while their gross non-performing asset (GNPA) ratio declined to 8.5% from 9.3% and the provision coverage ratio (PCR) improved to 65.4% from 61.6% over this period. The financial strength and stability of the SCBs were improving when the world was hit by COVID 19.

2.4 Phase 4 (2020)

As the system was stabilizing and regaining its strength, the nationwide lockdown due to COVID 19 has introduced a ton of uncertainty.

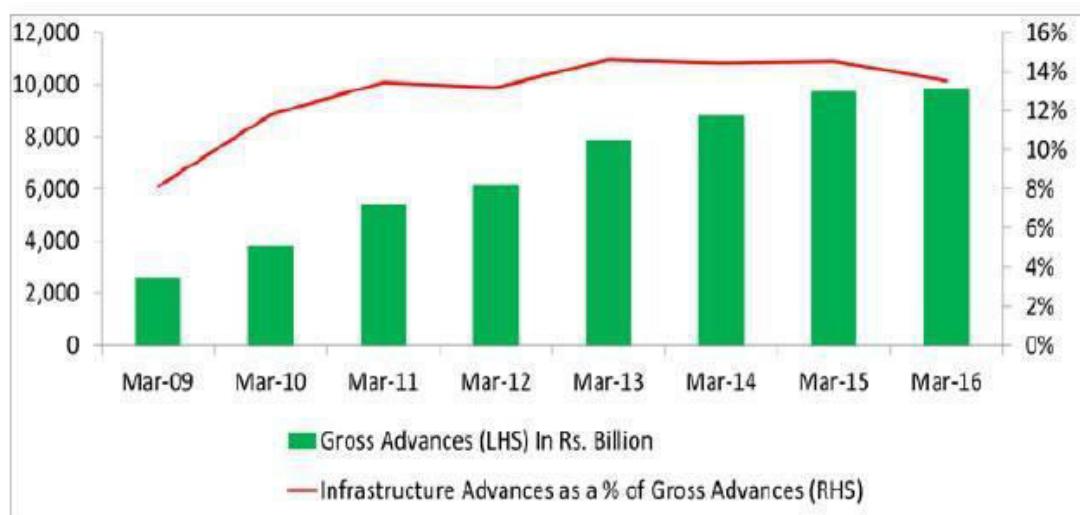
It has affected both the consumer demand and the production capacity of the manufacturers. The effect of these problems has brought a lot of stress on the companies as there is a severe reduction in the cash flow. These companies have to bear fixed costs like rent, cost of maintenance of their production facilities, loan repayments, etc. With major reductions in revenues, the companies have to dip in their cash at hand and reserves. This has disturbed the

financial strength of the companies as the funds earmarked for future growth are getting used up for survival. The pandemic thus created a huge liquidity crisis for the companies. As the demand in the economy is at its lowest point, the growth in revenues in a couple of next financial quarters is going to be substandard. A huge number of companies are either going under or have to raise funds. A proportion of those companies are going to raise funds through debt. Due to the lack of financial strength in a huge number of companies spread out over a wide range of sectors, there is going to be an increase in the GNPs.

RBI has conducted various stress tests on assets for the foreseeable future. Macro stress tests for credit risk indicate that the GNPA ratio of all SCBs may increase from 8.5% in March 2020 to 12.5% by March 2021 under the baseline scenario; the ratio may escalate to 14.7% under a very severely stressed scenario. The effect of the pandemic has stressed 2 sectors more than the others.

2.4.1 Infrastructure Sector

To understand the effect of the pandemic on the infrastructure sector, understanding its history is essential. After the emergence of private-public partnerships in the Indian setup, there was a significant push from the government towards improvement in the infrastructure sector in 2006. Keeping the trend in mind, institutions in the financial sector reflected over-optimism and started lending without the required due diligence. The percentage of advances for the infrastructure sector to the total value of Gross Advances rose intensively.



(Source: RBI supervisory returns and staff calculations)

The NPAs and the restructured assets in this segment have increased quite substantially. The Gross NPAs and restructured standard advances for the infrastructure sector, together as a percentage of total advances to the sector, has increased considerably from Rs. 121.90 bn (4.66%) as at the end of March 2009 to Rs.1369.70 bn (17.43%) as at the end of March 2013. (*Infrastructure Financing By Banks In India: Myths and Realities*, n.d.) The infrastructure projects have large capital requirements and long gestation periods. The gestation period refers to the amount of time the project takes to generate cash flow. This develops into a liquidity problem for the banks. They are not able to earn any income on huge amounts of assets at least for the initial years of the projects. As the financial exposure of the banks in each project is huge, the risk in this sector is tremendous.

The infrastructure sector possesses 36.2% of the total gross advances given to the industry. The proportion of GNPs to the total gross advances has been an average of 16 % in 2018 to 2019. In the Indian financial sector, the GNPA ratio of the infrastructure sector is more than the GNPA ratio of the SCBs in a respective year. In March 2020 the GNPA ratio of the infrastructure sector was 13.1% and the GNPA ratio of the SCBs was 8.5%. The condition of the sector before the pandemic was unstable. (*Infrastructure Financing By Banks In India: Myths and Realities*, n.d.)

After the pandemic, there has been a halt in the majority of projects due to the lockdown. The cost of infrastructure projects are huge. The fixed costs include the rents, maintenance of the equipment, and interest payments. It has impacted the financial strength of the companies tremendously. The large-scale migration of the workers due to the lockdown has created a huge deficit of the labour force to rejoin the projects. When the projects resumed, there was an increase in the cost of labour as well as the safety equipment required because of the pandemic. All the above-mentioned factors are creating financial obstacles for the projects which may lead to an increase in the price of the final product. The pandemic has also hit the disposable income of consumers who are going to generate demand. Thus, the financial risk for the infrastructure sector has increased even more after the pandemic.

2.4.2 Power Sector

The Power Sector has been hit severely by the pandemic as it operates on the demand generated by all the other industries and sectors. The lockdown was a period where the capacity utilization of the sector went to zero. The growth rate of electricity demand in India

in 2020 is around 6%. (The Impact of COVID-19 on the Power Sector, n.d.) The overall power demand declined by 26% in May 2020. The complete lockdown of more than 2 months has impaired the earnings of the power companies. The decline in power demand has started improving but there is a lot of time for the demand to come back to the pre-COVID-19 level. When a power plant is working on less than full capacity, the average cost of a unit of power generated would be more than the full capacity utilization period. This continuing period of less than full capacity utilization is going to affect the earnings and subsequently, the liquidity for the power companies. They will not be able to repay their obligations.

The power sector under infrastructure pushes the already financially unstable sector off a cliff. The unstable condition before the pandemic coupled with the challenges posed by the pandemic is placing the entire infrastructure sector in line for having a huge GNPA ratio in the foreseeable future.

2.4.3 Steel Sector

The Steel sector is directly related to the manufacturing industry of India. It is a highly capital-intensive sector and subsequently, it consumes a huge amount of loans from the SCBs.

Iron and Steel Sector's Stressed Assets

Year	Share in Total Advances (%)	Share in Stressed Advances (%)
March 2009	3.9	5.1
March 2010	4.1	7.8
March 2011	4.4	7.7
March 2012	4.6	6.7
March 2013	4.9	8.1
September 2013	4.7	9.2

(Financial Institutions: Soundness and Resilience, 2013)

Traditionally the stressed assets of the sector were increasing in the economy. The total exposure of the steel industry stood at about Rs 3.20 lakh crore, out of which gross NPAs were about Rs 1.15 lakh crore (37%) as of 2018 (Rai, 2018). The proportion of NPAs in gross advances is increasing in the sector. It shows that the companies in the sector are finding it difficult to pay back their obligations.

After the economy was put under lockdown due to the pandemic, the situation of the steel sector worsened. The effect of reduction in manufacturing has reduced the demand drastically. Due to this reduction in demand, the sector has accumulated a lot of inventory. The cost of holding inventories for heavy equipment is substantially high. The lockdown has created a situation of oversupply. This will bring the prices down and subsequently cut profit margins of steel companies. Due to the above-mentioned difficulties, there is going to be a severe liquidity crisis for companies in the steel sector and it is going to be difficult for them to pay back their obligations. The Steel Sector has one of the highest GNPA ratios to gross advances which is going to get even worse in the foreseeable future.

To provide some room for the companies to survive RBI has introduced a Moratorium for loan payments.

3.0 Moratorium

The existence of COVID related restrictions like the nation-wide lockdown and the increase in unemployment has created a need for a change in the repayment schedule of loans. The Reserve Bank of India announced a moratorium of 3-months on loan EMIs on March 27, 2020, which was later extended for another 3 months till August 31, 2020. A moratorium is a period in which the loan repayment is deferred. The moratorium would be considered as a change in terms and conditions of the loan and not as an asset degradation. The 90-day NPA norm does not apply to the moratorium period. Due to the moratorium, the SCBs would receive reduced interest incomes for 6 months. The banks are going to have a couple of quarters with reduced earnings. They are also going to face a liquidity problem. The financial strength of the banks is getting to its low point. With the moratorium reducing the earnings and the liquidity and the possibility of a sharp increase in NPAs in the coming year, the banks are in desperate need of liquidity and policy measures.

4.0 Committee for Restructuring of Loans

RBI has formed a five-person committee to vet the restructuring of loans above Rs.1500 crore. The committee will have to recommend financial parameters to screen the loans based on liquidity, debt credibility, and leverage. This is going to be a single time restructuring of loans due to the financial instability created by the pandemic. This restructuring will help in preventing a sudden increase in the GNPAAs of large borrowers which will burden the system as well as bring a lot of companies to Insolvency. Restructuring the loans will give the

companies time to capitalize on the re-generated demand and get to the pre-COVID level of earnings and liquidity.

5.0 Suggestions

The major problem that the banks and the companies are facing in the post-COVID 19 period is liquidity. They need to stay afloat and wither the harsh conditions imposed by lack of demand because of the pandemic. For banks to survive without getting consumed in the bubble of NPAs, they need liquidity and aggregate demand generating policy measures supporting the economy.

The suggestions are divided into 2 parts.

5.1 Measures by the Central Government

The effect of the pandemic has been two-fold. It has reduced the aggregate demand in the economy as well as disturbed the supply chains. Government spending is an essential tool to generate aggregate demand in the economy. Aggregate Demand refers to the total demand generated by the consumption expenditure, investment expenditure, government spending, and the value of net exports (Value of Export – Value of Import). Due to the reduction in income of employees as well as the companies, the income generated by the Government is also reduced. The Government has to raise money through several measures like taking dividend payments from the RBI, charging high taxes on harmful products like liquor and cigarettes, etc.

The Government spending needs to be directed to specific sectors for the coming 3 years. They need to provide demand injections to the sectors that are highly impacted by the pandemic and employ a large proportion of the population. These sectors are Infrastructure, Steel, Tourism, and Aviation. Essentially, the Government needs to budget its spending to the sectors that need it the most for the next 2-3 years. It needs to act as a supporting bridge to help the companies get through these tough times. To support the supply chain issue, the Government has already announced the ‘Atma Nirbhar Bharat Abhiyan’. It promotes the MSEs with collateral-free loans and provides debt to the MSEs which will be converted to equity to expand their businesses. This will help India to develop its supply chains.

If the demand and supply in the economy are supported by the Government for the next 3 years, the companies are going to grow back to the pre-COVID 19 earnings and financial

stability. This coupled with the one-time restructuring of the loans will help the financial system to get ahead of the increasing NPAs and prevent it from deteriorating the financial strength of the SCBs.

5.2 Measures by the Reserve Bank of India

The banks need immediate and sustained liquidity:

i. Reduction in Repo Rate

Repo Rate refers to the rate of interest at which the commercial banks borrow money from RBI. A reduction in Repo Rate will essentially increase the amount of money the commercial banks are going to earn and it will contribute to solving their liquidity problem. The RBI should keep a reduction in repo rate in its liquidity measures it has to provide to the SCBs for the next few years.

ii. Long-Term Repo Operations (LTRO)

Under LTRO, RBI provides long term loans at current repo rates which essentially reduces the cost of funds for the SCBs. It is a great liquidity injection. It can be done in trenches over time. Thus, it fits perfectly in the liquidity injections mix required by RBI to act as a support for the SCBs for liquidity. Certain policy restrictions need to be introduced in the banking sector to help them sustain the effect of defaults and NPAs.

iii. Mandatory Provisions for NPAs

RBI should mandate the SCBs to maintain a provision out of their profits to cover the estimated NPAs and defaults that make their way in the next quarter. This is going to safeguard the banks from the financial shock and help them weather the storm without harming their core.

iv. Capping of Sector-wise exposure of Gross Advances

RBI should conduct a sector-wise risk analysis in terms of stressed assets and the prospects of an increase in stressed assets. Subsequently, based on the results of the analysis there should be capping for gross advances extended to each sector by a particular bank. This policy is going to reduce the amount of risk the banks undertake and justifiably diversify their holdings across different sectors. It is a hedge for future uncertainty.

6.0 Conclusion

The Indian banking sector was lending over-optimistically when the world was hit by the financial crisis of 2008. After the effect of the crisis came into the system, the GNPsAs increased exponentially. The state of the Indian banking system deteriorated because of the high proportion of NPAs. To rectify the situation, RBI along with the Central Government came with policy changes like the Insolvency and Bankruptcy Code and 4R's strategy to speed up the process of resolution and recovery of non-performing assets of the banks. The situation started improving and the banks were re-capitalizing their financial strength and stability when the world was hit by the pandemic (COVID 19).

The reduction in consumer demand and disturbances in the supply chains has created liquidity problems for different sectors in the economy. The earnings of the companies have taken a great hit and are going to be disturbed for the foreseeable future. Their ability to pay back their obligations is also going to get weakened. Subsequently, the GNPA ratio of the SCBs is going to increase sharply in the coming 3 years. The authorities need to interfere and support the different sectors of the economy simultaneously in terms of liquidity and generating aggregate demand, so the companies can weather the storm created by the pandemic and the banking system can maintain its strength and stability. Under the proposed policy, the Government needs to direct its spending to sectors that are hit more severely and thus, require huge liquidity and demand injections. This should be carried out for the next 3 years so it supports the companies throughout the rough time. The RBI needs to provide liquidity to the banks with different tools in their mix like reduction in repo rate and long-term repo operations for the next 3 years.

To hedge against the risk of uncertainty in the future, there should be mandatory policies to cap the percentage of gross advances that can be lent to a particular sector and for maintaining a provision for estimated NPAs out of the profits. All these measures can help the banking sector to stay afloat in the post-COVID 19 periods without harming their financial strength and stability.

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