IIMC-CRC-2022-07

IIMC Case Research Centre (IIMCCRC)

Sahadeb Sarkar, Kirit Ghosh

February 2023

ABCD Bank: In Search Of Factors Affecting Its Interest Income

After a hectic day at office, before winding up for the day, Arun finally found some time to sit and contemplate on the activities of the day, sipping his coffee. He recalled the high-level meeting, which he had attended in his first week of internship in May 2022. The leadership was worried that post the pandemic, when the economy begins to recover, there might be a massive spurt of NPA, which in turn, could affect the bank's interest income levels. Specifically, the leadership feared that a mismatch between the expected and actual interest income would result in a steep devaluation of the bank's stocks. Moreover, what bothered the leadership even more was the fact that within the ongoing recovery phase, the Russia-Ukraine war had thrown some of the significant macroeconomic variables (e.g., export and import figures, Industrial Production Index (IPI), Consumer Price Index (CPI)) completely out of gear. Thus, for the leadership, it was all the more relevant to analyse and understand the role of NPAs on the bank's interest income.

Having completed his MBA from a premier Management institute in India, Arun has been pursuing a three-month post-graduate internship at ABCD Bank before joining a multinational financial corporation as a full-time employee. The bank had entrusted him with the arduous task of navigating through the huge amount of public data available and bring to light to what extent the bank's Non-Performing Assets (NPAs) impact its interest income. By now, he had realized the gravity of the challenge that he had at hand. Largely, in the context of the Indian banking industry, NPAs have been the Achilles' heel for quite some time now. In fact, ever

---

This case was written by Sahadeb Sarkar and Kirit Ghosh of the Indian Institute of Management Calcutta. The case was prepared solely to provide material for classroom discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation and they cannot be held liable for any loss or profit resulting from the use of the concepts highlighted in the case.

since the Covid-19 outbreak in 2019-20, several reports have speculated the rise of NPAs within the Indian banking sector, especially now, as the world economy limps back to normalcy (i.e., pre-Covid times).

Owing to his stellar academic records in the finance courses, Arun is well aware of the problems that banks face due to NPAs. His focus would be more on studying its impact on the bank's interest income. Any adverse impact on the same, might lead to a steep devaluation of its stock prices. Effectively, this justifies studying the NPAs' role on interest income, owing to its extreme criticality for the bank management to avoid such devaluation by the stakeholders. Further, it may be noted that with the high-profile cases of Vijay Mallya and Nirav Modi[1] gaining widespread prominence, it becomes all the more important to understand the following: apart from the concomitant macroeconomic factors, to what extent NPAs are responsible for affecting the core income of a private sector lender, such as the ABCD Bank.

With the interest income and the NPA data for every quarter, culled from the annual financial reports available before him, Arun needed to decide which among these macroeconomic factors (e.g., GDP, money supply, rate of inflation etc.) should be considered as possible explanatory variables. As a Management graduate, he did realize that managing the overall analysis with multiple variables to analyse would be quite tricky. The best way forward he thought would be to perform a regression analysis. Looking at the plots and the various parameters to decide the goodness of fit, it would help him to give his manager a model that possibly best explains the extent of the impact of NPAs on ABCD's interest income.

Arun thought to himself that with a quantitative model, ABCD's leadership would be able to explain to the shareholders how far NPA has been responsible for the loss in interest income, and to what degree other macroeconomic conditions that are beyond the ambit of ABCD bank's management are responsible for the same.

Arun was happy at the thought that he would be able to give his manager and the bank's leadership at large, a model that would help in understanding the impact of NPA. The model presumably would make handling the questions of the shareholders considerably easier post declaration of the quarterly results of the bank. He was worried about the lack of time to finish the analysis and prepare the report. He needed to ensure that the final report would be concise but contain enough details for the reader.

[1] https://www.news18.com/news/india/where-are-vijay-mallya-and-nirav-modi-now-a-news18-primer-as-india-plans-to-raise-pending-extraditions-during-boris-johnson-visit-5010295.html, retrieved on 20 June 2022

Non-performing assets have always been a spot of bother for lenders. The slow legal process in India makes the process of recovery of the loaned amount too cumbersome for the bank. For every NPA, the bank usually loses most of the principal amount; in some cases, a part of the principal (loaned) amount can be recovered with the help of a recovery agent. However, the bank would surely lose the interest income associated with the NPAs and not achieve its targeted interest income for the quarter. Despite this banks cannot move away entirely from risky assets. As they reach out to a broader gamut of clients, the risk factor increases, and there is a higher chance of the loaned amount turning into a substandard asset instead of generating an interest income. In 2020, the coronavirus pandemic changed the world order. The Reserve Bank of India (RBI), India's central bank and regulatory body responsible for governing the Indian banking system, came out to save the economy in firefighting mode by making structural changes to the banking system such as extension of realisation period of export proceeds and implementation of countercyclical capital buffer. In particular, it lowered the repo rate[2] so that consumers could easily access loans. Two years later, with the pandemic receding, hopes of returning to normalcy are rising. The Indian economy might have weathered through the pandemic; the loans given out during the covid-19 pandemic will now ideally start to generate income in the form of interest. However, there is a massive fear in the banking industry that since the economy is still not back to normal, many individuals and corporates who had access to easy credit during the pandemic will now find it difficult to repay them. They might not still have sources of steady income[3]. While the high inflation implies that people will need to spend more on their day-to-day needs, including food, housing, and transport, their income might not increase to that extent to repay debts. With inflation having crossed RBI's threshold limit of 6 percent[4], Arun watched RBI declare an increase in repo rate by 50 basis points on June 8, 2022[5].

2 https://timesofindia.indiatimes.com/business/india-business/rbi-reduces-repo-rate-by-40-bps-from-4-4-to-4-key-points-of-shaktikanta-dass-speech/articleshow/75883240.cms, retrieved on 20 June 2022

3 https://indianexpress.com/article/business/banking-and-finance/third-covid-wave-bankers-npa-surge-7714998/ , retrieved on 20 June 2022

4 https://www.rbi.org.in/

5 https://www.thehindu.com/business/Economy/rbi-increases-repo-rate-by-50-basis-points/article65506344.ece , retrieved on 20 June 2022