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SPECIAL COMMENTARY

Amendment to 'parate' rights – boon or bane?

The proposed amendment to the applicability of parate rights to loans below Rs 5 million has created shockwaves among many financial institutions. This could adversely affect the speed of recovery for many bad loans. Nevertheless, this provision is not without its silver lining from a macro perspective.

A parate right or the right to foreclose and sell the mortgaged properties of defaulted loans, via board resolution and without going through a tedious legal process, had initially been granted to the state-owned commercial banks by their statutes. In 1990, this right was extended to all other commercial banks registered under the Banking Act and the Development Finance Corporation of Ceylon, under the Recovery of Loans by Banks (Special Provisions) Act, No. 4 of 1990. Through the Amendment No. 24 of 1995, the National Savings Bank as well as the two state-owned commercial banks have been brought under the ambit of this law. Other financial institutions, such as Housing Development and Finance Corporation Bank, State Mortgage and Investment Bank, and the Regional Development Banks, have all been bestowed this right via their respective Acts, which bring these institutions within the meaning of "banks" in the Recovery of Loans by Banks (Special Provisions) Act.

On the other hand, other financial institutions - including registered finance companies, specialised leasing companies, private savings and development banks, and other merchant banks - do not possess this right. Hence they are unlikely to be affected by this amendment.

The proposed amendment restricts the execution of parate rights to loans where the principal amounts are above Rs 5 million. Therefore, the right would not be exercisable on loans below the stipulated Rs 5 million. The rationale behind this amendment is to encourage lending based on the repayment capacity of the borrower, rather than their ability to offer adequate security or collateral. This has caused grave concern, especially among institutions with substantial exposure to small-scale loans (largely to the small and medium enterprises or the SME sector), as it could encourage wilful defaulters within existing portfolios and, in turn, deteriorate their asset quality. According to the Credit Information Bureau, nearly 95% of the total defaulted loans in its database are below Rs 5 million, with only 5% above this threshold.

Nevertheless, the details of this amendment have yet to be disclosed. Should it become applicable prospectively, the impact on the asset quality of lending institutions would be defined by their individual underwriting and monitoring standards. However, when lenders switch to cash flow based assessment for micro credit, there could be an initial "knee-jerk" reaction that could choke the disbursement of funds to this sector of the economy and impede potential growth. Though the lending rate is a function of many variables such as cost of funds, internal cost structure, nature of competition etc., the market may swiftly raise the credit risk premium for this segment and may increase the lending rates going forward. This is because the lender now has to evaluate the borrower's repayment capacity based on information that is said to be poor among many SMEs, leading to assessments based on uncertain and unreliable information; higher the element of uncertainty, higher the attached risk and in turn the risk premium. To this end, borrowers should make available adequate and reliable information so that the lenders can assess the inherent risks more objectively. In the longer term, however, credit assessments based on repayment capacity should result in better portfolio quality, which would enable the banks to price their products fairly in meeting market demand.

Moreover, banks need to transform themselves from their traditional collateral-based lending to a cash flow-based model at some point.

Meanwhile, this amendment is likely to slow down the portfolio growth of financial institutions that have been lending predominantly to the SME sector and yet do not possess the resources to evaluate the credit risks at the micro level, devoid of collateral. From a pure credit-risk perspective, however, this is likely to result in better portfolio quality over time as underwriting standards are stepped up while risk-management processes are fine-tuned.

Bad debts can be managed in two ways: proactively, with better underwriting standards and monitoring; or reactively, through focus on better recoveries and write-offs. The former is more likely to lead to sustainable asset quality, translating into a robust financial system. A prudent lender would take proactive measures because delays in collections and recoveries would entail additional costs. From a credit perspective, fewer incidences of new bad debts is deemed better than an excellent post-default remedy, as the former is a proactive measure.

Close supervision, on the other hand, would be paramount in maintaining the portfolio quality on an ongoing basis. In particular, frequent monitoring of project performance, field visits and staggered loan disbursement based on performance can become very handy in managing loans to SMEs.

Moreover, the importance of client-relationship management cannot be overemphasised. If managed properly, it should result in an overall improvement in the repayment habits of the borrowers in general. More importantly, lending based on proper evaluation will channel scarce financial resources to more commercially viable businesses and individuals that have the capacity to service their debts.

In the meantime, the BASEL II capital accord also recommends a favourable risk weighting on loans to the retail sector, requiring less capital allocation by the banks; this could render lending to this segment more enticing. Furthermore, in a free market, it can be argued that banks which adopt stringent underwriting standards can reduce their regulatory capital and hence either: (1) achieve a higher return on equity (“ROE”); or (2) be able to charge lower interest rates on loans and still maintain the same level of ROE.

All said, credit appraisal based on repayment capacity is a good practice and will certainly discipline lenders and borrowers alike - leading to a healthier credit culture. Nevertheless, it could be detrimental to institutions if enacted retrospectively. Since market participants are keen on developing the domestic bond market and the asset-backed securities (“ABS”) segment, any retrospective enactment will weaken the existing portfolio (built over a long period of time) as the ability of banks to easily enforce recovery on most of the defaulted loans would be taken away. This means that less benefit would be given to recovery assumptions in cash flow analysis, ultimately resulting in a higher level of credit enhancement. This would in turn result in higher cost for the issuer and/or increased risk to the ABS investors, which could-impede the growth of the ABS market.

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