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The Impact of Corporate Profitability and Economic Growth on Resolution of Distressed Assets in India

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ABSTRACT

Purpose: To study the impact of Indian corporate profitability and overall economic growth on the resolution of stressed assets in India, taking the effect of pandemic into consideration. The rationale behind the analysis has been excessive leverage, particularly in the non - financial Indian corporates with substantial share of domestic and external credit, and consequent rise in stressed assets even prior to the pandemic.

Methodology/Research Design: Multivariate OLS linear regression has been performed using annual recovery rate as dependent variable, whereas, annual profit after tax margin of Indian corporates and annual GDP growth at current prices as independent variables, respectively. Furthermore, a dummy variable has been introduced to the regression equation to study the effect of pandemic on recovery of stressed assets. Data has been sourced from the RBI, EPW and CMIE databases and HP filter has been used for smoothening of time series.

Findings: Findings suggest that, overall economic growth and corporate profitability may have a positive significant impact on the recovery/resolution of stressed assets and may contribute to achieve the desired financial stability. Whereas, pandemic may have a negative impact on the resolution process, however, the continued commitment towards the improvement of resolution may yield positive results.

Originality/Value: Attention towards transparency, accountability, credit monitoring, asset quality, structural evolution in the recovery laws, and improving the resolution framework may ensure achievement of the timely recovery of the stressed assets.

Paper Type: Empirical Research Paper

KEYWORDS: Financial Distress | Default | Resolution | Recovery | Economic Growth | Stressed Assets | Corporate Finance

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Introduction

In emerging economies, credit provided to corporates by the banking sector has always been instrumental in economic and productivity growth, nonetheless, also expedites government's long-term development goals. In addition, economic growth has been correlated with the financial wellbeing of the credit market and, consecutively, it may have a significant impact on easing the financial distress in the particular economy (Lodha, 2016).

However, in recent years, the rise in stressed assets has been challenging for the growth of free-flowing credit market in India. Moreover, the resolution of corporate financial distress may be necessary as it may affect 'ease of doing business index' of the nation, besides overall economic growth (Vikas, 2022). Therefore, the requirement of time-bound resolution of stressed assets has been evident in the present scenario. Various regulations, initiatives and legislatures have been enacted by the government for the resolution of stressed assets. However, the impact of resolution channels has been modest, considering the rise in quantum of stressed assets and evolutionary process of resolution. Most recently, Insolvency and Bankruptcy Code, 2016 have been enacted and resolution process has been improving (Khan, 2021).

The determinants of financial distress in the corporates may be firm/industry-level or macro-economic. However, excessive leverage in corporate accounts has been a cause of concern. Apart from the domestic credit to corporates by banking sector, non-financial corporations have surfaced as the largest borrowers with an outstanding debt of US Dollar 250.2 billion as at the end of financial year 2021-22 (GOI, 2022). In addition, domestic credit to non-financial corporates by banks as percentage of GDP has also been substantial, with an average of 51.09 percent (Fig.1). Thus, corporates form a substantial share in the gross advances of the banking sector, and resultant annual default rates (Fig. 2).

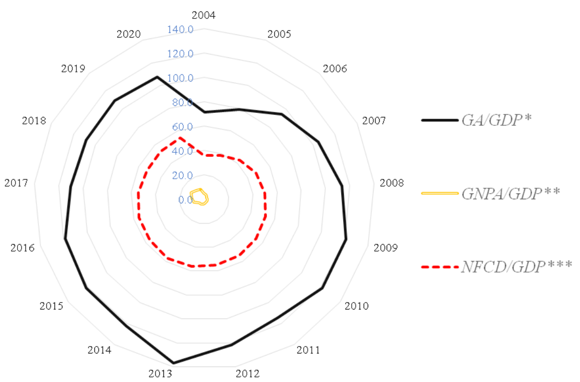

Fig. 1: ***Credit to non-financial corporates by banking sector, Gross NPA and gross advances as a percentage of GDP at current prices (2011-12 base) for the period 2003-04 to 2019-20***

*Gross advances as a percentage of GDP – Banking Sector.
**Gross NPA as a percentage of GDP – overall banking sector.
***Credit to non-financial corporates by banking sector as a percentage of GDP.

Source: Annexure II. Complied by author.

Furthermore, as per the asset provisioning regulations of the RBI, banks classify assets as standard, sub-standard and loss assets, according to their overdue timeframes. The 'loss assets' has been another cause of concern as the quantum of stressed assets written-off every year, has been at par with the quantum of stressed assets recovered (RBI 2022, p60). Thus, owing to the substantial share of corporates in gross banking credit, the profitability of Indian corporates and overall economic growth may significantly affect the resolution/recovery rate of stressed assets.

In the past, policy framework, fiscal control, and robust economic growth has protected India from the effect of global financial crisis, as evident in the literature. However, in the last 20 years, as per the data reported on Indian macroeconomic indicators, there has been a year-on-year rising trend in the default rates. Conversely, a declining trend may be seen in the recovery rates and overall profitability of Indian corporates (Fig. 2). However, strong economic growth facilitated the nation to overcome various shock scenarios in the past.

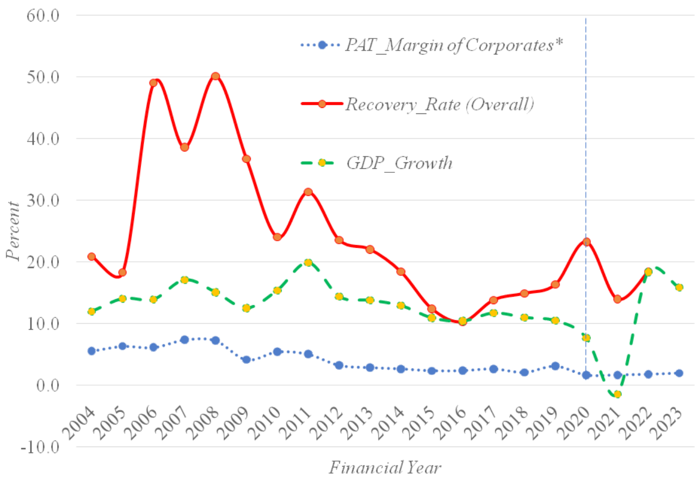

Fig. 2: Annual data trend of PAT Margin of corporates, GDP growth (y-o-y) at current prices (2011-12 base), recovery rate of stressed assets, and default rate for the period 2003-2020.

*Profit after tax margin of non-financial corporates.

Source: Annexure I. Compiled by author.

As evident in Fig. 2, a visible pandemic effect with decline in GDP growth and recovery rates may act as a structural break during the last two decades, apart from global financial crisis of 2008. Similar relationship has been evident in other emerging economies, where 2020-21 and 2021-22 financial years may be considered as an abnormal period owing to pandemic. However, trend has been visibly improving since 2016.

Accordingly, the analysis has been organised into five sections beginning with introduction followed by brief review of literature, covered in section II. Furthermore, section III, incorporated the research design and methodologies performed in the paper followed by data analysis and interpretations, which has been covered under Section IV, and finally, a conclusion and select recommendations has been presented, followed by relevant references and annexures.

Literature Review

Siraj and Pillai (2013) analysed the role of GDP in identifying the association between gross advances and gross NPAs of banking sector in India for the period 2001 to 2012, with special reference to global financial crisis. The results indicate that there has been a significant impact of GDP growth in analysing the association between gross NPAs and gross advances. The analysis suggests that, asset quality may be maintained regularly during the times of rising economic growth and proper provisioning must be provided.

Joseph (2018) analysed the NPAs in India for the period 2005 to 2015, related to commercial banks. Also, sectoral contribution of NPAs and its association with the productivity of banking industry has been explored. Furthermore, association between NPAs as a percentage of GDP and flow of credit has been analysed. Results indicate that NPAs has not been significantly influencing the flow of credit, however it impacts the profitability of banking sector and overall economic growth of the country.

Kattadiyil et al. (2020) suggested the path to reduce the default rate after analysing the credit market of India since global financial crisis. Analysis suggest that attention may be required for few alarming factors such as, accountability, credit monitoring/assessment, fraud detection/management, stricter laws for recovery, and forensic auditing. In addition, rise in recovery rate may bring down the default rates and improve the profitability of Indian Banks and overall economic growth.

Das and Uppal (2021) analysed the impact of certain firm-level and macroeconomic factors on profitability of Indian Banking sector using multivariate linear regression, comprised of data related to the period 2005 to 2019. Results indicate that the rising NPA may have a negative impact on the net income of Indian banking sector, whereas, GDP growth and capital adequacy has a significant positive impact on the income. Moreover, banks must curb the rise in NPAs to improve their efficiency and profitability.

Gaur and Mohapatra (2021) analysed the association between GDP growth and priority sector lending, as priority sector has been a major contributor to the NPAs for the period 2004-2018. Results suggest a significant positive corelation between GDP growth and priority sector lending, which translates to the involvement of priority sector lending in overall economic growth. In addition, results have been insignificant related to association between priority sector lending and annual default rate, which indicated that credit to priority sector has not contributed mainly in rising NPAs of banking sector.

Bajaj et al. (2021) analysed the association between NPAs and recovery rates for the period 1999 to 2018. Results indicate a significant negative relationship between them. In addition, it has been suggested that banks with high net margin, sufficient collateral, and adequate mix of term loans may well manage their portfolio to improve their asset quality and profitability.

Khan (2021) analysed the efficiency in regimes of recovery w.r.t cost of debt and debt structures, pre and post IBC, 2016. Input data have been taken for the period 2010 to 2020 with firm-level indicators such as, return on total assets, sales and profit margins, whereas, age, size and collateral has been taken as control variables. Results indicated that IBC, 2016 has improved the recovery market marginally, with a significant improvement in the overall performance of distressed corporates, and debt structures, and correspondent reduction in cost of debt.

Research Design

As evident in the review of literature, the majority of studies had focussed mainly on firm-level and macro-economic indicators impacting the banking sector, explaining the consequent rise in default rates. However, select issues and thoughts still remain as follows:

- How recovery rates may be improved in the macro-economic environment?
- Given the backdrop, how abnormal events affect the resolution/recovery process and how prepared the nation has been for any such events?
- How profitability of Indian corporates, along with the overall economic growth, collectively impact the resolution of stresses assets in India?

Accordingly, select issues formed part of the objectives of this paper, presented as follows:

I. Analysing the impact of economic growth and corporate sector profitability on resolution of stresses assets in the country.

II. Analysing the impact of pandemic on recovery/resolution rate, along with corporate profitability and economic growth.

For analysing the above objectives, secondary data has been sourced from the RBI, EPW and CMIE databases, and accordingly, variables have been selected for the analysis. Further to the analysis, *'annual recovery rate'* has been selected as a dependent variable, whereas, *'Annual GDP growth at current prices (2011-12 base)'* and *'Annual PAT margin of Indian corporates'* has been taken as independent variables. Consecutively, annual frequency data points for each variable, from 2003-04 to 2019-20, have been sourced from the mentioned databases and analysed using multivariate linear regression, with the following expression;

$$Y = a + B_1X_1 + B_2X_2 + e$$

Where, Y = 'annual recovery rate', B_i are the coefficients of independent variables and X_i are independent variables (X_1 = 'Annual PAT margin of Indian corporates' and X_2 = 'Annual GDP growth at current prices')

Further to the analysis, for servicing the second objective, a dummy variable has been introduced to the regression equation, to analyse the impact of pandemic on the resolution of stressed assets, with the following expression;

$$Y = a + B_1X_1 + B_2X_2 + C_1D_{1+}e$$

Where, Y = 'annual recovery rate', B_i are the coefficients of independent variables, X_i are independent variables (X_1 = 'Annual PAT margin of Indian corporates' and X_2 = 'Annual GDP growth at current prices'), and C_1 is the coefficient of dummy variable, and $D_1 = 1$ when the years are greater than and equals to 2019-20, otherwise 0.

Furthermore, HP-filter have been incorporated on the time-series data for addressing the trend and cyclicity component, and to attain a long-term perspective, using the following expression;

$$\min_{\tau}\left(\sum_{t=1}^{T}(y_t-\tau_t)^2+\lambda\sum_{t=2}^{T-1}[(\tau_{t+1}-\tau_t)-(\tau_t-\tau_{t-1})]^2\right).$$

Where, $\lambda = 100$, taken as smoothing parameter, prescribed for yearly frequency data time series.

Similarly, STATA software has been considered for the data analysis, and detailed information corresponding to all variables have been placed in the annexures, as specifically mentioned in the relevant sections.

Data analysis and Interpretation

As evident in the earlier sections, recovery rates have been declining year-on-year in the last two decades. However, with the introduction of IBC, 2016 – results have been continuously improving. Accordingly, 60.0 data points related to following three variables has been sourced for the period 2003-04 to 2022-23 and analysed using the model diagram presented as follows:

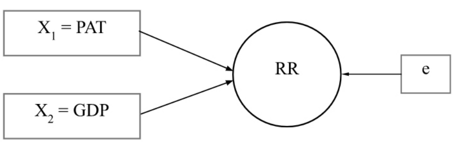

Fig 3: Recovery Rates

Where, GDP = 'Annual GDP Growth at current prices', and PAT = 'PAT Margin of Indian corporates', RR = 'annual recovery rate', and e = error term.

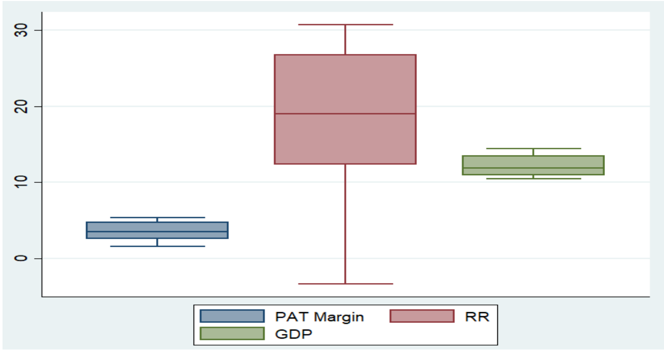

Fig 4: Box plot of the Variables Used in the Analysis

*RR = annual recovery rate, PAT Margin = Annual PAT Margin of Indian corporates and GDP = Annual GDP Growth at current prices.

Source: Annexure I. Compiled by the author.

Similarly, box plot of all the variables has been presented in Fig. 4 and represents the distribution of data in all the variables selected for the analysis.

Furthermore, the following underlying hypothesis has been assumed for performing multivariate linear regression on HP-filtered time-series using STATA.

H1: There has been a significant positive impact of X_1 and X_2 on 'Annual recovery rate' with B_1 and $B_2 \neq 0$.

Where, X_1 = Annual PAT margin of Indian corporates and X_2 = Annual GDP growth at current prices.

Subsequently, results indicate that the independent variables X_1 and X_2 has significantly predicted the dependent variable with F = 93.08, $p<0.05$. Therefore, annual PAT margin of Indian corporates and annual GDP Growth at current prices has a significant positive impact on annual recovery rates, with B_1 = 2.56 and B_2 = 2.59, respectively. Moreover, R^2 = 0.915 indicated that the model explained 91.5 percent of the variations in annual recovery rates (Table 1).

Table 1: Results of the multivariate linear regression using DV = 'annual recovery rate' and IDVs 'Annual PAT Margin of Indian corporates' and 'Annual GDP Growth at current prices'

RR	Coef.	Std. Err.	t-value	p-value	[95% Conf	Interval]	Sig
PAT	2.566	.454	5.66	0	1.609	3.523	***
GDP	2.591	.592	4.37	0	1.341	3.841	***
Constant	-19.308	6.288	-3.07	.007	-32.575	-6.041	***
Mean dependent var		22.810	SD dependent var			8.577	
R-squared		0.915	Number of observations			20	
F-test		92.084	Prob > F			0.000	
Akaike crit. (AIC)		98.278	Bayesian crit. (BIC)			101.265	

*H1 supported. *** p<.01, ** p<.05, * p<.1*

#GDP = 'Annual GDP Growth at current prices', and PAT = 'PAT Margin of Indian corporates', RR = 'annual recovery rate'

Source: Annexure III. Computed by the author.

Further to the analysis, a dummy variable has been introduced to the regression equation, for analysing the effect of pandemic on the resolution of stressed assets where, dummy variable – D = 1 when the years are greater than and equals to 2019-20, otherwise 0. Thus, following hypothesis has been assumed for the analysis;

H2: There has been a significant positive impact of X_1 and X_2 on 'Annual recovery rate' and a significant negative impact of D_1 on 'Annual recovery rate' with B_1, B_2 and $D_2 \neq 0$.

Where, X_1 = Annual PAT margin of Indian corporates, X_2 = Annual GDP growth at current prices and D_1 = Dummy variable for analysing pandemic effect.

Accordingly, results indicated that the independent variables X_1 and X_2 has significantly predicted the dependent variable with F = 74.98, p<0.05. Thus, annual PAT margin of Indian corporates and annual GDP Growth at current prices has a significant positive impact on annual recovery rates, with B_1 = 2.48 and B_2 = 2.20, respectively. In addition, pandemic has a significant negative impact on annual recovery rates, with C_1 = -3.69. Moreover, R^2 has been improved to 0.935 from 0.915, which indicated that the model with dummy variable has explained 93.4 percent of the variations in annual recovery rates (Table 2).

future. Illustratively, strong economic growth and incremental profitability of Indian corporates may contribute to achieve the desired financial stability. In addition, pandemic has affected the resolution process to a certain extent, however, the continued commitment towards the improvement of resolution has been started showing positive results.

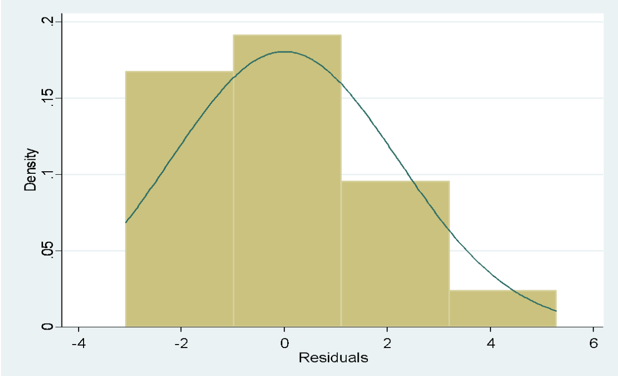

Fig. 5: Residuals histogram of the multivariate linear regression using DV = 'annual recovery rate' and IDVs 'Annual PAT Margin of Indian corporates' and 'Annual GDP Growth at current prices'

Source: Compiled by the author.

Table 2: Results of the multivariate linear regression using DV = 'annual recovery rate' and IDVs 'Annual PAT Margin of Indian corporates' and 'Annual GDP Growth at current prices'

RR	Coef.	Std. Err.	t-value	p-value	[95% Conf	Interval]	Sig
PAT	2.48	.417	5.95	0	1.597	3.363	***
GDP	2.201	.573	3.84	.001	.986	3.415	***
Pandemic_dummy	-3.699	1.771	-2.09	.050	-7.453	.050	**
Constant	-13.548	6.373	-2.13	.049	-27.059	-.037	**

Mean dependent var	22.810	SD dependent var	8.577
R-squared	0.934	Number of observations	20
F-test	74.982	Prob > F	0.000
Akaike crit. (AIC)	95.457	Bayesian crit. (BIC)	99.440

*H2 Supported. *** p<.01, ** p<.05, * p<.1*

#GDP = 'Annual GDP Growth at current prices', and PAT = 'PAT Margin of Indian corporates', RR = 'annual recovery rate'

Source: Annexure III. Computed by the author.

Therefore, results validate the hypothesis that annual year-on-year growth of GDP and annual profit after tax margin of corporates may have a positive and significant impact on the recovery of stresses assets, whereas, pandemic impacted resolution of stressed assets negatively. The histogram of residuals surfaced in the regression analysis have been presented in Fig 4.

Thus, priorities of the nation may be concentrated towards improving the recovery rates marginally in the near

Conclusion

In the last 20 years, there has been a consistent rise in the default rates and resultant rise in the distressed assets lying in the financial statements of the banking sector. In addition, declining trend in recovery rates due to various factors may have contributed to the urgent requirement in resolution of distressed assets. Furthermore, the non-financial corporates have the substantial share of stressed assets, both in domestic and external debt accounts of the nation, which may be seen as a cause of concern.

Furthermore, the analysis indicates that GDP growth and corporate profitability may have a positive impact on the recovery of stressed assets. Similarly, pandemic has a significant negative impact on recovery/resolution of stressed assets. Moreover, default rates may continue to rise and recovery capacity may be overwhelmed, in the near future. Accordingly, following are select key recommendations for preventing future unfavourable events:

- Attention towards transparency, accountability, credit monitoring, asset quality monitoring, and stricter evolution in the laws for recovery.
- Improving the corporate profitability or curbing the further growth of stressed assets.
- Expanding/improving the resolution infrastructure/ framework for ensuring the strict implementation of enacted timeframes for resolution of stressed assets.

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The Editorial Board had used the Turnitin – a Swedish anti-plagiarism software tool which is a fully-automatic machine learning text-recognition system made for detecting, preventing and handling plagiarism and trusted by thousands of institutions across worldwide. Ouriginal by Turnitin is an award-winning software that helps detect and prevent plagiarism regardless of language. Combining text-matching with writing-style analysis to promote academic integrity and prevent plagiarism, Ouriginal is simple, reliable and easy to use. Ouriginal was acquired by Turnitin in 2021. As part of a larger global organization GJEIS and Turnitin better equipped to anticipate the foster an environment of academic integrity for educators and students around the globe. Ouriginal is GDPR compliant with privacy by design and an uptime of 99.9% and have trust to be the partner in academic integrity (https://www.ouriginal.com/) tool to check the originality and further affixed the similarity index which is {06%} in this case (See below Annexure-I). Thus, the reviewers and editors are of view to find it suitable to publish in this Volume-15, Issue-2, Apr-Jun 2023.

Annexure 15.2.1

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Reviewers Memorandum

Reviewer's Comment 1: The paper provides a comprehensive analysis of the impact of corporate profitability and economic growth on the resolution of distressed assets in India. The introduction provides a clear background and rationale for the study, highlighting the importance of resolving stressed assets for the overall economic growth of the country.

Reviewer's Comment 2: The literature review is well-structured and provides a good overview of previous studies in this area. The inclusion of various studies analyzing different aspects of the relationship between GDP growth, corporate profitability, and recovery rates adds depth to the discussion. The research design and methodology section is thorough and clearly explains the data sources and variables used in the analysis.

Reviewer's Comment 3: The inclusion of relevant charts and data in the introduction and literature review sections helps to provide a visual representation of the trends and relationships discussed. This enhances the reader's understanding and engagement with the paper.

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Editorial Excerpt

The article has 04% of plagiarism which is the accepted percentage as per the norms and standards of the journal for publication. As per the editorial board's observations and blind reviewers' remarks the paper had some minor revisions which were communicated on a timely basis to the authors (Shashank and Ajay), and accordingly, all the corrections had been incorporated as and when directed and required to do so. The comments related to this manuscript are noticeably related to the theme "**The impact of corporate profitability and economic growth on resolution of distressed assets in India**" both subject-wise and research-wise. The paper addresses an important topic and provides valuable insights into the impact of corporate profitability and economic growth on the resolution of distressed assets in India. The introduction effectively highlights the challenges posed by stressed assets and the need for timely resolution. The literature review is comprehensive and includes studies that analyze various aspects of the relationship between GDP growth, corporate profitability, and recovery rates. This adds depth to the discussion and helps to establish the research gap addressed by the current study. After comprehensive reviews and the editorial board's remarks, the manuscript has been categorized and decided to publish under the "Empirical Research Paper" category.

Acknowledgement

The acknowledgment section is an essential part of all academic research papers. It provides appropriate recognition to all contributors for their hard work and effort taken while writing a paper. The data presented and analyzed in this paper by authors (Shashank and Ajay) were collected first handily and wherever it has been taken the proper acknowledgment and endorsement depicts. The authors are highly indebted to others who facilitated accomplishing the research. Last but not least, endorse all reviewers and editors of GJEIS in publishing in the present issue.

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