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The Role of Non-Performing Assets in Indian Banking Sector

Shio Kumar Prasad[1], Dr. Uttam Kumar[2]
[1]Research Scholar, [2]Assistant Professor
Department of Commerce, RKDF University, Ranchi
[1]Email id: shiv.kr9304@gmail.com
[2]Email id: uk153135@gmail.com

Abstract:

Banking sector plays a vital role in the economic development of a country. A healthy financial system and an efficient economy are dependent on a sound banking sector. The Indian banking sector has gone through a significant transformation after the economic reforms in 1991.This transformation and the big size have exposed banking sector to various kinds of risks such as credit, operational, market and liquidity risks. Non-performing assets (NPAs) is one of the major risks being faced by the banks (Public as well as Private) today as it has lowered the profits of the banks. **NPA** plays an important role in every economic condition and also the main cause of the increase in the current account deficit. Interest rates, Loan, Housing Loans, CRR, and SLR all are directly affected by the system.

Keywords: Banks (Public as well as Private Sector Banks), Non-Performing Assets, Types of NPA and role of NPA.

Introduction:

For any nation, banking system plays a vital role in the development of its sound economy. The banking sector is the lifeline of any modern economy. It is one of the important financial pillars of the financial sector, which plays a vital role in the functioning of an economy. It is very important for economic development of a country that financing requirements of trade, industry and agriculture are met with higher degree of commitment and responsibility. Thus, the development of a country is integrally linked with the development of banking.

NPA is nothing but old wine in new bottle. The bad loans which were known as Bad Debts has been renamed as Non-Performing Assets as per the Narsimham Committee recommendations. Previously banks used to write off the bad debts as per their own decisions depending upon the health of the banks. But Narsimham Committee prescribed a standardized norm for provisioning of NPAs. Narsimham Committee was implemented in all banks in the year 1991. The committee also classified the assets in different categories and rates of %age for provisioning.

Reasons of Study/ NPAS:

Multiplicity of factors is responsible forever increasing size of NPAS in banks. A few prominent reasons for assets becoming NPAs are as under. Speculation (Investing in high risk assets to earn high income) Lack of co-ordination between banks, Default borrowers. Fraudulent practices, Poor credit appraisal system. Changes in economic policies. Reckless advances to achieve the budgetary targets. No transparent accounting policy and poor auditing practices.

The Present study being empirical and comparative has been undertaken to examine the NPAs. It's impact on profitability of public & private sector banks. Multiplicity of factors like poor credit appraisal system, not having proper monitoring, to reach their goals, advances are given fecklessly, poor auditing practices, poor marketing practices, poor recovery system are responsible forever increasing size of NPAs in banks. Thus the main aim of the research study is to examine that how the NPAs has affected the profitability, competitive functioning of banks and finally the philosophy of the bankers in respect of their disposition towards credit delivery and credit expansion.

NPA (Non-Performing Asset) is a critical factor which has adversely impacted the development and growth of the economy. This research discusses the impact of NPAs on the profits of banks. This research attempts to analyze the impact of few important financial heads on NPAs of banks and to suggest on effective management of NPAs. According to RBI data, five banks (public and private) with highest NPAs were taken for the study for period 2014-2015 to 2018-2019. The research applied correlation analysis to compute the relationship between net profits and NPAs and multiple regression analysis to determine the impact of important financial heads on NPAs.

Problem Identification:

Non-performing assets of banks are one of the biggest hurdles in the way of socio-economic development of India. The level of NPAs of the banking system in India is still too high. It affects the financial standing of the banks so that it is a heavy burden to the banks. A vigorous effort has to be made by the banks to strengthen their internal control and risk management systems and to setup early warning signals for timely detection and action. The problem of NPAs is tied up with the issue of legal reforms. This is an area which requires urgent consideration as the present system that substantially delays in arriving at a legal solution of a dispute is simply not tenable. The absence of a quick and efficient system of legal redress constitutes an important 'moral hazard' in the financial sector, as it encourages imprudent borrowers.

NPAs can create many challenges. Some of the important challenges are:

- Owners do not receive a market return on their capital. In the worst case, if the bank fails, owners lose their assets. In modern times, this may affect a broad pool of shareholders.
- Depositors do not receive a market return on savings. In the worst case if the bank fails, depositors lose their assets or uninsured balance. Banks also redistribute losses to other borrowers by charging higher interest rates. Lower deposit rates and higher lending rates repress savings and financial markets, which hampers economic growth.
- Non-Performing loans epitomize bad investment. They misallocate credit from good projects, which do not receive funding, to failed projects. Bad investment ends up in misallocation of capital, labour and natural resources. The economy performs below its production potential.
- Non-Performing loans may spill over the banking system and contract the money stock, which may lead to economic contraction. This spillover effect can channelize through illiquidity or bank insolvency:
    - When many borrowers fail to pay interest, banks may experience liquidity shortages. These shortages can jam payments across the country.
    - Illiquidity constraints bank in paying depositors e.g. cashing their paychecks. Banking panic follows a run on banks by depositors as part of the national money stock become inoperative.
    - The money stock contracts and economic contraction follows, under capitalized banks exceeds the bank's capital base.

The present study has been designed to achieve these objectives:

- To know and study about the non-performing assets in Indian Banks
- To find out Non-Performing Assets under the Priority sector lending in Indian Bank and Compare with Public Sector Banks (PSBs),
- To make appropriate suggestions to avoid future NPAs and to manage existing NPAs in Indian Bank.
- The major scope of this study covers on the basis:
    - Measuring for the banks to avoid future NPAs & to reduce existing NPAs,
    - Guiding for the government in creating & implementing new strategies to control NPAs,
    - Selecting appropriate techniques suited to manage the NPAs and develop a time bound action plan to arrest the growth of NPAs.

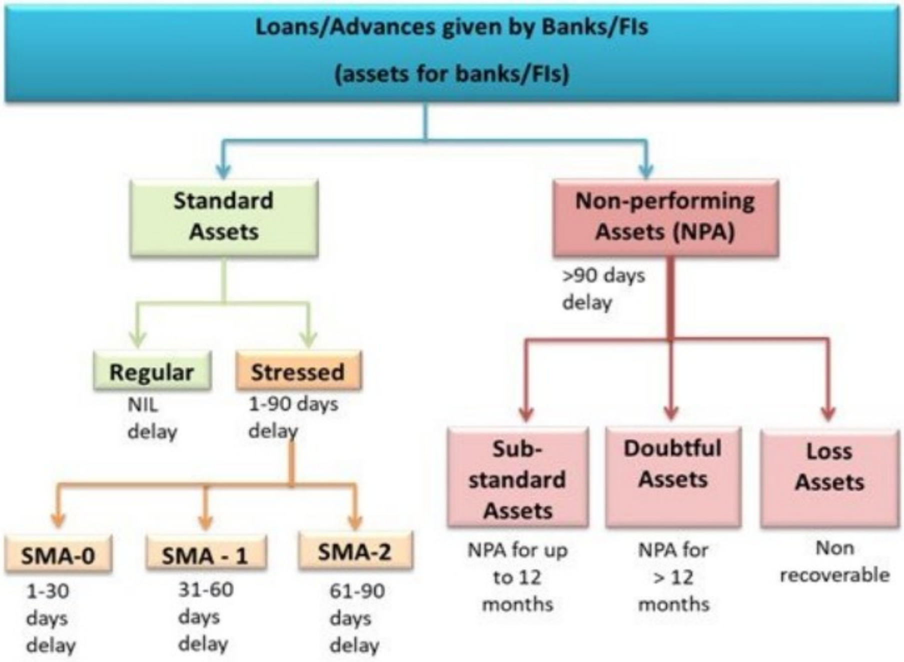
Non-performing Assets (NPAs) – Meaning:

According Reserve Bank of India - An asset becomes NPA when it ceases to generate income for the bank. A non-performing asset (NPA) is a loan or an advance where:

- Interest and / or installment of principal remain overdue for a period of more than 90 days in respect of a term loan.
- The account remains out of order in respect of an overdraft/Cash Credit (OD/CC).
- The bill remains overdue for a period of more the 90 days in the case of bills purchased and discounted.

Categories of Non-Performing Assets:

- **Standard Assets**: It does not create any problem while paying interest/ installments of the principal. It usually carries more than normal risk attached to the business.
- **Substandard Assets**: An asset is classified as a sub-standard asset if it remains as an NPA for a period less than or equal to 12 months.
- **Doubtful Assets**: An asset is classified as a doubtful asset if it remained as an NPA for more than 12 months.
- **Loss Assets**: An asset is considered as loss asset when it is uncollectible and it has not been written off wholly or in parts.



Gross NPA and Net NPA:

Gross NPAs are the sum total of loans and advances that have been converted into non performing because of defaulting borrowers. It comprises of substandard, doubtful and loss asset, which is classified as per the guidelines issued by RBI. Gross NPA determines the quality of bank's loans and advances portfolio Computation of Gross NPA for the financial year - Gross NPA = (Opening Balance of Gross NPA (+) additional NPA of the year (-) (Upgradations / Recoveries (excluding recoveries made from upgraded accounts) / Technical/ Prudential Write-offs / Write-offs).

$$\textbf{Gross NPAs Ratio} = \frac{\boldsymbol{Gross\ NPAs}}{\boldsymbol{Gross\ Advances}}$$

Net NPA:

Bank makes provision against non-performing assets which includes specific provision as per the type of asset, provisioning guidelines are issued by RBI. After deduction of such provision from Gross NPA we may arrive at Net NPA. Computation of Net NPA for the financial year - Gross NPA – (Balance in Interest Suspense account + DICGC/ECGC claims received and held pending adjustment + Part payment received and kept in suspense account + Total provisions held).Banks must make provisions and capital buffers while its earning a good profit which it can utilize for managing losses in future. This practice will ensure the stability of financial sector. Therefore banks were advised to maintain 70% PCR, consisting of specific provisions against NPAs as well as floating provisions.

$$\textbf{Net NPAs Ratio} = \frac{Gross\ NPAs - Provisions}{Gross\ Advances - Provisions}$$

Provisioning is a process where certain amount from profit is kept for providing a security cover to non-performing assets. After the classification of NPAs Provisions have to be made against each category of NPAs based on certain norms. The above classification is intended to provide the basis for determining provisions for loss. It also helps in supervision and follow up of advance for recovery. Taking into account the time lag between an account becoming doubtful of recovery its recognition as such, the realization of the security and the erosion over time in the value of security charged to the bank, the bank should make provisioning against substandard assets, doubtful assets and loss assets as belongs.

Literature Review:

In the banking literature, the problem of NPAs has been revisited in several theoretical and empirical studies. A synoptic review of the literature brings to the fore insights into the determinants of NPA across countries.

The problem of NPA was first brought into focus by the Narasimham Committee on financial system (1991), set up with the initiation of liberalization process in the country. Narasimham Committee clearly defined that an asset may be treated as Non-performing Asset (NPA), if interest or installments of principal or both remain unpaid for a period of more than 180 days. However, with effect from March 2004, default status is given to a borrower account if dues not paid for a period of 90 days. According to the prudential norms, an asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank. RBI guidelines defined that NPAs consist of substandard assets, doubtful assets and loan assets. Any asset usually turns as NPA when it fails to yield income during a certain period.

Objectives of Study:

Unprecedented growth of non-performing assets has been a matter of great concern to the RBI, the government, the financial institutions and even the banks. There are several internal and external factors affecting NPA level. The purpose of this study is to analyse the present position of non-performing assets in selected public sector and private sector banks and to provide ways for the removal of this menacing problem of non-performing assets. Therefore, it is the objective of the present study to have an in-depth analysis of NPAs and suggest suitable measures to bring its level down especially in selected banks.

- To compare the quantitative degree of NPAs among Public Sector & Private Sector Banks.
- To find out the impact of NPA over Banking Industries.
- To find the preventive as well as curative measures to overcome the increasing problem of NPA.
- To evaluate an effective NPA management system for a sound banking system.
- To examine the existing structure of the financial system of banks and its various components and to improve the efficiency and effectiveness of the system with particularly reference to the economy of operations, accountability and profitability of the commercial banks and financial institutions.

Impact of NPAs on Banking Operations:

High NPAs may not be favourable for a bank. This is because they are assets that are not performing. High NPAs mean that banks have too many loans that have become non-functional or are not rendering any interest income to the bank. Banks can either keep the NPAs in their books in the hope that they may be able to recover it or make provisions for it. Or else, banks write off the loans entirely as bad debt. However, there are many other factors to assess a bank apart from NPA.

Collection of Data:

The analysis is mainly base on secondary data. However, Personal interviews and discussions were also held with managing director of the banks, other bank officials and experts in the field. The primary data was collected by observation and personal discussions. The following sources have been used in the collection of secondary data.

- Report on trends and progress of banks in India.
- Report on currency and finance.
- Statistical tables related to banks in India.
- RBI Bulletins
- RBI Occasional Papers.

- Banking Statistics.
- Journals and other publications of the Indian Institute of bankers.
- Bulletins of Indian Bank Association.
- Annual Reports and Balance Sheets of Selected Banks (SBI, PNB, HDFC, ICICI).

For in-depth analysis of NPAs in Selected Banks, the relevant authorities were approached and the required disaggregated data was collected personally from the head office of the selected banks.

Effects of NPAs:

If it is analysed critically it would be evident that the banks started incurring losses after implementation of Narsimham Committee recommendations. Due to provisioning of assets in standardized form, the erosion of capital of the banks started. Thereafter the concept of strong banks and weak banks came into effect. For survival of weak banks the government started recapitalizing the weak banks.

RBI and government started pressuring the banks to implement stringent methods for recovery of the NPAs and to improve their balance sheets.

On critical analysis it has been observed that major portion of NPAs is contributed by several top industrialists. Generally the NPAs in agriculture and priority sector is comparatively lower than that of the corporate houses. It is said that due to government policies of waiving agriculture loans in cases of floods, droughts and natural calamities burden of NPAs of all PSBs is increasing. Generally marginal farmers and small entrepreneurs pay their loans in due time which is evident from surveys by different agencies.

Though the government has enacted SARFAESI Act in 2002 that empowered the banks to acquire the mortgaged land, building, etc. and dispose the same in auction for recovery of bad loans but the banks are still facing problems while implementing the said Act.

Reasons for the Rise in NPAs:

Some are macroeconomic factors such as lower exports due to global recession, downturn in commodity price cycles, etc.

Most of today's NPAs are from loans in the mid-2000s, when the economy was booming and business confidence was buoyant. But as economic growth stagnated post the global financial crisis of 2008, the repayment capacity of these borrowers declined. This lead to what is called the India's Twin Balance Sheet problem, where both the banking sector and the corporates are reeling under financial stress.

Also political factors like chronic capitalism caused high NPAs in India.

Further, recently there have also been frauds of high magnitude that have contributed to rising NPAs. Although the size of frauds as compared to the total volume of NPAs is relatively small, these frauds have been increasing, and there have been no instances of high profile fraudsters such as Vijay Mallya, Nirav Modi and Mehul Choksey being penalised.

Corrective Action Plan to Arrest increasing NPAs:

Banks must identify early that there is going to be a non-payment and report it to the Central Repository of Information on Large Credits (CRILC).

Preventive Measures:

- Evaluate borrower's Credit Information Bureau (India) Limited (CIBIL) score.
- Compromise or use various settlement schemes.
- Use alternative dispute resolution mechanisms for faster settlement of dues such as use Lok Adalats and Debt Recovery Tribunals.
- Actively circulate information of defaulters.
- Take strict action against large NPAs.
- Use Asset Reconstruction Company.
- Legal Reforms such as implementation of the Insolvency and Bankruptcy Code have already taken place.
- Corporate Debt Restructuring (CDR).
- Propose guidelines on willful defaults/diversion of funds.
- Special Mention Accounts – Additional Precaution at the Operating Level.

Latest Measures by RBI:

The main provisions are;

- Lenders' Committee with strict timelines for a resolution plan to be established.
- Lenders must be given incentives to agree to collectively and quickly plan
- Improvement in current restructuring process focus on viable plans and a fair sharing of losses between promoters and creditors.
- Future borrowing for non-cooperative borrowers with lenders must be made more expensive in resolution.
- Asset sales must be given more liberal regulatory treatment.
- If loss is fully disclosed, lenders must be allowed to spread their losses on sale for over two years.
- It will not be construed as restructuring if takeout financing is made possible over a longer period.
- If specialized entities are acquiring 'stressed companies', leveraged buyouts must be allowed.
- Steps must be taken to facilitate better functioning of Asset Reconstruction Companies.
- Sector-specific Companies/Private equity firms must be helped to play an active role in the stressed assets market.

Loans Moratorium on Banks and NPAs:

Banking sector performance had improved in FY20. Several PSU banks which were having high NPAs reported growth in earnings. Then the Covid-19 crisis emerged and loan moratorium was announced by RBI.

RBI had announced loan moratorium on banks to salvage borrowers due to Coronavirus. Loan moratorium means that the borrowers will not be required to pay interest and principal components of the loan to the bank during the moratorium period. This is to encourage borrowers to increase their spending and businesses to thwart low business confidence and expand and continue their businesses buoyantly so that economic growth does not be spoiled.

A stress test conducted by the RBI suggests that the RBI could push Indian banks' gross bad loans to their highest in nearly two decades. Gross NPA declined to 8.5% in 2020 from 9.3% in 2019. Gross NPAs would rise to 15.2% by March 2021 from 11.3% a year earlier in the baseline scenario. In the "very severe stress" scenario, this could go as high as 16.3%.

Credit growth to corporates form 37% of total bank assets and generates 73% of NPAs. Credit growth to industry slowed to 0.8% in July 2020 as compared with 6.1% growth in July 2019. Credit growth to food processing, mining, petroleum, coal & nuclear fuels, leather, wood industry, paper increased in July 2020. Sectors hit hard by the pandemic are tourism, aviation, entertainment, hospitality, petroleum, real estate and food. Sectors performing well are pharmaceuticals, FMCG, ecommerce, utilities and IT sectors. Loans to these sectors are not likely to turn bad. However, credit growth to chemicals, plastic, infrastructure, gems & jewellery, glass and beverage & tobacco decreased. So we see that credit growth to sectors hit by pandemic will generate high NPAs. Retail lending forms 22% of total bank lending and generates 3.7% of NPAs. Car loans, home loans and personal loans have low delinquencies and are good loans. Personal loans performed well growing by 11.2% implying NPAs from this segment will be low and banks will enjoy higher margins.

Conclusion:

Repo rate has been lowered substantially by the RBI since some time but banks have not much lowered their lending rates because of financial sustainability. So with the growth of loans in H1FY21 will translate into good earnings for banks despite the pandemic. Once moratorium is lifted and repayments start coming banks will become profitable. NPAs would rise and in this aspect RBI has asked banks to do provisioning, buffers and raise capital and thus be resilient organizations. All banks are facing lot of problems due to various reasons. PSBs are lifeline of the Indian economy and government should nourish them for their sustainability. Only mergers of banks are not the only tool for economic growth. Interference by various political parties in functioning of the banks must be stopped.

Suggestion for Reducing NPAs:

- It is the onus on the concerned bank which has given the loan to tackle the problem of NPA. Therefore the recommendation of Narasimham committee which suggest that the asset management companies or assets recommendation fund must redress the NPA to be reviewed

- A Strong banker-Borrower relationship should be improved. Forceful recovery by the banks, which is against corporate. Debt recovery will be much easier in a friendly atmosphere.
- Supporting the Borrowers in developing his entrepreneurial skills will establish a good relation between the borrowers. But also help the bankers to maintain a track if their resources.
- Public sector banks should be allowed to come up with their own method to address the problem of NPAs. It includes surrendering and reducing the principle and interest on such loans, extending the loans, or settling the loan accounts. They should be fully authorized and apply all the privileged policies granted to the asset management companies.
- Another way to manage the NPAs by the banks is compromise Settlement Schemes or One Time Settlement Schemes or One time settlement Schemes. Under these situations, it is necessary to bring more simplicity in such deals so that any mistake could be removed.

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