

The Increasing Incidence of Non-Performing Assets of Indian Banks

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ABSTRACT

Non-Performing Assets (NPAs) constitute a major scary collection in the Banks portfolio and is increasingly becoming an inexorable burden on the banking industry in India. The impact of NPA is multi-pronged and phenomenal on various counts. An increasing incidence of NPAs may cause severe strain on bank finances, loss of confidence of depositors leading to a run on deposits and the consequent deleterious impact on the competitive powers of banks. Their continued augmentation in absolute terms proved the survival of Indian banks very difficult. The phenomenal increase in NPAs and willful defaults over the last few years raises serious concerns about the effectiveness of NPA management and its mechanisms. By improving credit risk management, conducting necessary sensitivity analysis and contingency planning in project appraisals, strengthening credit monitoring, enforcing accountability and creatively addressing corporate governance issues are some of the ways out to stand up to this menace.

1. Introduction

NPA refers to a classification for loans on the books of financial institutions that are in default or are in arrears on scheduled payments of principal or interest. In most cases, debt is classified as nonperforming when loan payments have not been made for a period of 90 days. It represents a loan asset, which has become barren and layoff to produce any income for a bank whether in the form of interest or principal repayment. As per the prudential norms suggested by the Reserve Bank of India (RBI), a bank cannot book interest on NPAs on accrual basis. In other words, such interests can be booked only when it has been actually received. Therefore, this has become a critical, vulnerable and sensitive area of the banking sector as most of the banks in India are either at the slippery verge or in the NPA debacle. NPAs are also called as Non-Performing Loans (NPLs). With the introduction of international norms for income recognition, asset classification and provisioning in the banking sector, managing NPAs has emerged as one of the major challenges facing Indian banks. Banks today are judged not only on the basis of number of branches and volume of deposits but also on the basis of quality of assets. Non-performing assets constitute a major collection in the Banks portfolio and hence are an inevitable burden on the banking industry in India. NPAs adversely affect the profitability, liquidity and solvency of the banks. They have been detrimental to the efficient performance of Indian banks. Their continued accumulation in absolute terms proved the survival of Indian banks very difficult.

2. Literature review

A considerable amount of research has been done on NPAs of banks by academicians, researchers, policy-makers etc. Berger and De Young (1997) made one of the pioneering attempts to understand the reasons behind NPAs, applying Granger-causality techniques which sought to test four hypotheses regarding the relationship between loan quality, cost efficiency and bank capital. According to him these four hypotheses were referred to as "bad luck", "bad management", "skimping", and "moral hazard" of which the bad management

hypothesis was superior to the others. Espinoza and Prasad (2010) trying to distinguish the determinants of NPAs found that the NPA ratio rises when economic growth slows and risk aversion decreases as well as when interest rates increase. Kaur K. and Singh B. (2011) in their study on Non-performing assets of public and private sector banks studied that NPAs are considered as an important parameter to judge the performance and financial health of banks. Rai (2012) in her study on Study on performance of NPAs of Indian commercial banks finds out that corporate borrowers even after defaulting continuously never had the fear of bank taking action to recover their dues. This is because there was no legal framework to safeguard the real interest of banks. Kumar (2013) in his study has said that NPAs have become a nuisance and headache for the Indian banking sector for the past several years. Singh (2013) in his paper entitled Recovery of NPAs in Indian commercial banks says that the origin of the problem of burgeoning NPA's lies in the system of credit risk management by the banks. Zahoor Ahmed and M. Jagadeeshwaran, (2013) had summed up that NPA is a major problem and barrier faced by the banking industry, attributing it to causes like willful default, improper processing of loan proposals, poor monitoring and follow up and so on. Sonia Narula & Monika Singla (2014) in their research paper found that Because of mismanagement in bank there is a positive relation between Total Advances, Net Profits and NPA of bank which is not good. Bank is unable to give loans to the new customers due to lack of funds which arises due to NPA.

3. Importance of the study

The problem of NPA has been haunting Indian Banks from earlier on and which got its tentacles widely spread over banks assets, financing capability and clogging balance sheets, particularly after the global financial crisis. The impact of NPA is multi-pronged and phenomenal on various counts. An increasing incidence of non-performing assets may cause severe strain on bank finances, loss of confidence of depositors leading to a run on deposits and the consequent deleterious impact on the competitive powers of banks. The

ensuing banking crisis can impact on the whole economy in diverse ways, such as undermining confidence in the country or suppressing the future growth rate of GDP. The phenomenal increase in NPAs and willful defaults over the last few years raises serious concerns about the effectiveness of NPA management and its mechanisms. Given the potential adverse impact that the increasing incidence of NPAs might cause, it is critical that NPA resolution takes place in a timely manner. Non-Performing Assets which are notoriously called as NPA's by the banking sector have become a pain for both public and private sector banks in India. Policies concerning NPA resolution must address two critical aspects: first, how to prevent it occurring at this scale in the future and second, how to manage the existing accumulated NPAs. According to the RBI's statistical tables relating to banks in India NPAs were 3 per cent of gross advances of all banks in India in 2013 which rose by to 9.3 per cent in 2016 and to 10.5 percent in 2018. For the 10 worst PSBs, gross NPAs averaged 16.4 per cent of gross advances. When restructured and unrecognised assets are added the total stress would be 15-20 percent of total loans. This bad performance is not a good sign and can result in crashing of banks as happened in the sub-prime crisis of 2008 in the United States of America. Therefore, it is of paramount importance to understand and identify the factors that affect NPLs so as to sort out ways to address this menace which would improve the credit policies of banks to consolidate their lending policies and asset portfolios.

4. Objectives

1. To identify the causes of NPAs of banks in India
2. To understand the impact of NPAS of banks in India
3. To study the growth of NPAS of banks in India

5. Methodology

The study is descriptive and analytical, based on secondary data collected from different sources and analysed using appropriate techniques of analysis.

6. Classification of Assets

6.1 Substandard Asset

Assets remained none performing for a period not less than or equal to one year. In such cases, the current net worth of the borrower or guarantor or market value of the security charged is not enough to ensure recovery of the bank's dues; likely to sustain some loss if deficiencies are not corrected.

6.2 Doubtful Asset

It represents NPAs remained in substandard category beyond 1 year which makes recovery highly questionable and improbable. It requires 100% of the finance not secured by the realizable value of the leased asset as Provision.

6.3 Loss Asset

Asset considered uncollectible and of little value but not written off wholly by the bank and continue as bankable assets although it may have some salvage or recovery value. They are to be written off or 100% of the sum of the net investment in the lease and the unrealised portion of finance income net of finance charge component.

7. Reasons for the rise in NPA in recent years

During the boom phase between early 2000 and 2008, Banks especially Public sector banks lent extensively to corporates often without sufficient evaluation of risks and returns, to finance major projects proposals in capital-intensive sectors such as power, ports, airports, housing and highway construction. However, the profits of most of the corporate dwindled due to slowdown in an exuberant milieu that started and continued until three years after the global financial crisis of 2008 necessitated the ban in mining projects, and delay in environmental related permits affecting power, iron and steel sector, volatility in prices of raw material and the shortage in their availability. This has affected their repayment capacity which stands out as the most conspicuous reason behind increase in NPA of banks.

Things started worsening with the policy paralysis brought about by the spectrum and coal mining scandals. Soon, most projects were getting stuck, especially in power and highways; and banks found their loans going acerbic. Yet another reason for the rising NPA is the relaxed lending norms loaded in favour of corporate idols (eg. The Mallyas and Nirav Modis) when their financial status and credit rating is not analyzed properly. Corollary to the above, to ward off competition banks are enormously selling unsecured loans on LOU based on partisan consideration, which also attributes to the level of NPAs. Public Sector banks provide around 80 percent of the credit to industries and it is this part of the credit distribution that forms a great chunk of NPA. For instance when kingfisher was tainted in financial crisis, SBI provided it huge amount of loan which it is not able to recover from it. Banks did not conduct adequate contingency planning, especially for mitigating project risk. They did not factor eventualities like business failures of varied types. This is followed by priority sector lending and education loans constituting 20 percent of banks NPA, the repayment of which is indefinitely delayed and in most cases uncertain. External Factors like recession Input/power storage, Price escalation, Exchange rate fluctuation, Accidents and natural calamities, changes in government policies in excise/ import duties, pollution control orders, etc. rule the roost. Some of the other factors also affected NPA which are mention below.

- Absence of Bankruptcy code and the languid legal system in India make it difficult for banks to recover loans from both corporate and non-corporate borrowers.
- Failure to stick to the fundamental principles of lending
- Diversification of funds to unproductive purposes.
- Lapses due to negligence when loan is advanced.
- Unplanned expansion of corporates during boom period financed at a low rate which might be subsequently serviced at high rates, resulting into NPAs.
- Deliberate attempts by the corporates to willfully default and thereby jeopardise the loan repayment schedule.
- Mal governance and policy paralysis which hampers the timeline and speed of projects, therefore, loans become NPAs.

- Diversion of funds by companies for purposes other than for which loans were taken.
- Restructuring of loan facility extended to companies that were facing larger problems of over-leverage & inadequate profitability.
- Companies with dwindling debt repayment capacity were raising more & more debt from the system.
- Inefficiencies in post disbursement monitoring regime.
- Under political pressure banks are compelled to provide loans for certain sectors which are mostly stressed
- Corporates often take the legal route which is time consuming leading to problems for the banks

8. Impact of NPAs

- NPAs squeeze the profit earning capacity of banks
- Banks are left with lesser money available to fund other projects, which have negative impact on the larger national economy.
- High levels of NPAs affect the image and goodwill of banks and financial institutions.
- Banks are forced lend at higher interest rates and levy user charges etc to keep the profit margin intact, putting extra burden on borrowers.
- Provisions have to be made for NPAs, which again eats away the profits of banks.
- Balance sheet of banks and financial institutions wear an unpleasant look due to stressed assets reflected in the balance sheet.
- Higher levels of NPAs indicate rather a weak management, which tends to de stabilize and slow down the recovery process
- It might lead to corporate evils like watering of capital and over capitalisation
- The wealth maximization objective gets paralyzed as the growth prospects becomes faint
- NPAs related cases add more pressure to already pending cases with the judiciary.
- NPAs result in increased carrying, administrative, legal and recovery costs.
- Subsequent public issue offerings of banks and financial institutions will be adversely affected.
- Cost of Capital will increase due to high NPAs and require economic value added, Lower growth and higher inflation
- NPAs cause to decrease the value of share sometimes even below their book value in the capital market.
- On the whole the credibility of the banks will under scanner which would land banks in a precarious position in finding fresh sources of finance from the capital market.

9. Recovery Channels

9.1 The Debt Recovery Tribunals

The establishment of DRTs to decrease the time required for settling cases under the provisions of the Recovery of Debt Due to Banks and Financial Institutions Act, 1993 has to a certain extent come to the rescue of banks in the face of NPAs and their recovery. However they could not produce the

desired results since their number is not sufficient and therefore they also suffer from time lag and cases are pending for more than three years in many circumstances.

9.2 Credit Information Bureau

The services the Bureau are very valuable since its roll out in 2000. They help banks by maintaining and sharing data of individual defaulters and willful defaulters through a good information system which helps prevent loans falling into bad hands and thereby minimizing the incidence of NPAs.

9.3 Lok Adalats

The advent of Lok Adalats in 2001 is highly helpful in tackling and recovery of small loans though they are limited up to 5 lakh rupees loans only by the RBI guidelines issued in 2001. Notwithstanding the fact they deal with smaller amount of NPAs, because of their coverage touching the bottom of the pyramid the possibility of more NPA cases being dragged into the legal system can be effectively checked.

9.4 One Time Settlement Schemes

The Reserve Bank of India (RBI) mandate states that banks must have a loan recovery policy that is responsible for negotiations and settlement of non-performing assets. Accordingly, one-time Settlement (OTS) schemes are available in all banks as an effort to deal with NPAs. It is a type of compromise settlement executed by the banks in order to recover non-performing assets (NPAs). OTS is a scheme where the borrower proposes to settle all the dues at once, and banks agree to accept an amount lesser than what was originally due. The banks settle the loan and waiver/write it off against a one-time installment, thereby compromising on a portion of their profits. When a loan account becomes delinquent and turns into an NPA, banks are required to settle it as per the RBI guidelines.

9.5 SARFAESI Act

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 permits Banks / Financial Institutions to recover their NPAs without the involvement of the Court, through acquiring and disposing of the secured assets in NPA accounts with an outstanding amount of Rs.1 lakh and above. The banks have to first issue a notice. Then, on the borrower's failure to repay, they can take ownership of security and/or Control over the management of the borrowing concern and appoint a person to manage the concern.

9.6 ARC (Asset Reconstruction Companies)

An Asset Reconstruction Company is a specialized financial institution that buys the NPAs or bad assets from banks and financial institutions so that the latter can clean up their balance sheets. Or in other words, ARCs are in the business of buying bad loans from banks. The RBI gave license to 14 new ARCs recently after the amendment of the SARFAESI Act of 2002. These companies are created to unlock value from stressed loans. Before this law came, lenders could enforce their security interests only through courts, which was a time-consuming process.

9.7 Corporate debt restructuring

Corporate debt restructuring is the reorganization of a distressed company's outstanding obligations to restore its liquidity and keep it in business. The system was commenced in 2005. It is often achieved by way of negotiation between distressed companies and their creditors, such as banks and other financial institutions, by reducing the total amount of debt the company has, and also by decreasing the interest rate it pays while increasing the period of time of repayment.

9.8 Joint Lender Forums

It was created in 2014 by the inclusion of all PSBs whose loans have become stressed. It is present so as to avoid loan to same individual or company from different banks. It is formulated to prevent the instances where one person takes a loan from one bank to give a loan of the other bank.

9.9 Bad Banks

In the report published by the Economic survey in 2016-17, it insists about the formation of a bad bank which would take all the stressed loans and it will tackle it according to flexible rules and mechanism. It will ease the balance sheets of banks giving them the space to fund new projects and continue the funding of development projects. The bad bank shall be given special working norms, relaxations and privileges.

10. Recent Trends in NPAs

It is evident from Tables 1.1 that the Gross and Net NPA of SCBs shows ominous growth with a CAGR of 26 and 30 percent respectively over the past twelve years from 2005-06 to 2016-17. Similarly the NPA ratio as a percentage of advances and total assets also register substantial increase during the same period. Thus there is a meteoric rise in NPA in content and coverage, raising serious questions against the quality of bank assets. As it can be seen from Tables 1.2 and 1.4 that the situation is more or less similar in the case of Public Sector Banks and New Private Sector Banks. This might be attributed to liberal lending policies backed by weaker repayment mechanisms. However when it comes to Old Private Sector Banks as in Tables 1.3, the situation is much better and in most cases under control. This could be attributed to the conservative lending policies followed from the beginning coupled with sticking to sound principles of lending. The problem of NPAs and bank frauds hang like a Damocles Sword over the finances of banks amidst a host of other challenges, which might lead to bank failure resulting in tremendous loss to depositors and stakeholders. The Mallyas and NiravModis have not yet fallen asleep; they might rise up again venomously.

Table 1.1

Gross and Net NPAs of Scheduled Commercial Banks Banks								
(Amount in ` Billion)								
Year (end-March)	Advances		Non-Performing Assets (NPAs)					
	Gross	Net	Gross			Net		
			Amount	As Percentage of Gross Advances	As Percentage of Total Assets	Amount	As Percentage of Net Advances	As Percentage of Total Assets
1	2	3	4	5	6	7	8	9
2005-06	15457.30	15168.11	517.53	3.3	1.9	185.43	1.2	0.7
2006-07	20074.13	19812.37	505.17	2.5	1.5	202.80	1.0	0.6
2007-08	25034.31	24769.36	566.06	2.3	1.3	247.30	1.0	0.6
2008-09	30246.52	29999.24	699.54	2.3	1.3	315.64	1.1	0.6
2009-10	32620.79	34967.20	817.18	2.5	1.4	391.27	1.1	0.6
2010-11	39959.82	42974.87	939.97	2.4	1.3	417.99	1.0	0.6
2011-12	46488.08	50735.59	1369.68	2.9	1.6	652.05	1.3	0.8
2012-13	59718.20	58797.73	1927.69	3.2	2.0	986.93	1.7	1.0
2013-14	68757.48	67352.13	2630.15	3.8	2.4	1426.56	2.1	1.3
2014-15	75606.66	73881.60	3229.16	4.3	2.7	1758.41	2.4	1.5
2015-16	81711.14	78964.67	6116.07	7.5	4.7	3498.14	4.4	2.7
2016-17	84767.05	81161.97	7902.68	9.3	5.6	4330.10	5.3	3.1
CAGR(%)	15	15	26			30		

Source: Hand book of RBI Statistics on Indian Economy

Table 1.2

Gross and Net NPAs of Public Sector Banks								
(Amount in ` Billion)								
Year (end- March)	Advances		Non-Performing Assets (NPAs)					
	Gross	Net	Gross			Net		
			Amount	As Percentage of Gross Advances	As Percentage of Total Assets	Amount	As Percentage of Net Advances	As Percentage of Total Assets
1	2	3	4	5	6	7	8	9
2005-06	11347.24	11062.88	421.17	3.7	2.1	145.66	1.3	0.7
2006-07	14644.93	14401.46	389.68	2.7	1.6	153.25	1.1	0.6
2007-08	18190.74	17974.01	406.00	2.2	1.3	178.36	1.0	0.6
2008-09	22834.73	22592.12	459.18	2.0	1.2	211.55	0.9	0.6
2009-10	25193.31	27013.00	573.01	2.3	1.3	296.43	1.1	0.7
2010-11	30798.04	33044.33	710.42	2.3	1.3	360.55	1.1	0.7
2011-12	35503.89	38773.08	1124.88	3.2	1.9	593.91	1.5	1.0
2012-13	45601.69	44728.45	1644.61	3.6	2.4	900.37	2.0	1.3
2013-14	52159.20	51011.37	2272.64	4.4	2.9	1306.35	2.6	1.6
2014-15	56167.18	54762.50	2784.68	5.0	3.2	1599.51	2.9	1.8
2015-16	58219.52	55935.77	5399.56	9.3	5.9	3203.76	5.7	3.5
2016-17	58663.73	55572.32	6847.33	11.7	7.0	3830.89	6.9	3.9
CAGR %	15	14	26			31		

Source: Hand book of RBI Statistics on Indian Economy

Table 1.3

Gross and Net NPAs of Old Private Sector Banks								
(Amount in ` Billion)								
Year (end- March)	Advances		Non-Performing Assets (NPAs)					
	Gross	Net	Gross			Net		
			Amount	As Percentage of Gross Advances	As Percentage of Total Assets	Amount	As Percentage of Net Advances	As Percentage of Total Assets
2005-06	851.54	829.57	37.59	4.4	2.5	13.75	1.7	0.9
2006-07	948.72	928.87	29.69	3.1	1.8	8.91	1.0	0.6
2007-08	1134.04	1116.70	25.57	2.3	1.3	7.40	0.7	0.4
2008-09	1303.52	1285.04	30.72	2.4	1.3	11.59	0.9	0.5
2009-10	1563.57	1541.36	36.22	2.3	1.3	12.71	0.8	0.5
2010-11	1872.96	1846.47	36.00	1.9	1.2	9.00	0.5	0.3
2011-12	2329.18	2300.79	42.00	1.8	1.1	13.00	0.6	0.3
2012-13	2731.20	2699.37	52.10	1.9	1.2	20.00	0.7	0.4
CAGR%	16	16	4.0			5.0		

Source: Hand book of RBI statistics on Indian economy

Table 1.4
Gross and Net NPAs of New Private Sector Banks

(Amount in ` Billion)								
Year (end- March)	Advances		Non-Performing Assets (NPAs)					
	Gross	Net	Gross			Net		
			Amount	As Percentage of Gross Advances	As Percentage of Total Assets	Amount	As Percentage of Net Advances	As Percentage of Total Assets
2005-06	3151.01	3129.62	75.99	2.4	1.3	31.70	1.0	0.6
2006-07	4182.41	4147.51	91.45	2.2	1.2	40.28	1.0	0.5
2007-08	5236.99	5184.02	129.22	2.5	1.4	56.47	1.1	0.6
2008-09	5751.67	5753.28	167.87	2.9	1.6	74.12	1.3	0.7
2009-10	5795.35	6324.41	173.07	3.0	1.5	65.06	1.0	0.6
2010-11	7232.05	7975.44	179.05	2.5	1.3	44.32	0.6	0.3
2011-12	8716.41	9664.03	182.10	2.1	1.1	44.01	0.5	0.3
2012-13	11512.46	11432.40	203.82	1.8	1.0	59.94	0.5	0.3
2013-14	13602.53	13429.35	241.84	1.8	1.1	88.62	0.7	0.4
2014-15	16073.39	15843.12	336.90	2.1	1.3	141.28	0.9	0.5
2015-16	19726.59	19393.39	558.53	2.8	1.8	266.77	1.4	0.8
2016-17	22667.21	22195.63	919.15	4.1	2.6	477.80	2.2	1.3
CAGR%	18	18	23			25		

Source: Hand book of RBI Statistics on Indian Economy

11. Conclusion

Having attempted to understand the intricacies of NPA and its varied impacts on different organs of the economy particularly that of banks, it is apparent that Indian banks are trapped in bad loans. The problem of NPA has thus been haunting Indian Banks which got its tentacles widely spread over banks assets, financing capability and clogging balance sheets, particularly after the global financial crisis. The phenomenal increase in non-performing assets (NPAs) and willful defaults over the last few years raises serious concerns about the effectiveness of NPA management and its mechanisms. The perpetrators have not yet fallen asleep; they might rise up again. The banks shall invariably stick to the basic principles of lending based on safety, security and productivity of advances given. It is highly promising to see that

the government has launched 'Mission Indradhanush' to make the working of public sector bank more transparent and professional in order to curb the menace of NPA in future along with the introduction of the proposed Bankruptcy code. The initiatives taken by the RBI in last few years which include tightening the Corporate Debt Restructuring (CDR) mechanism, setting up a Joint Lenders' Forum, prodding banks to disclose the real picture of bad loans and so on are praiseworthy. Once it starts producing the desired result, the NPA fiasco may be more positively addressed. By improving credit risk management, conducting necessary sensitivity analysis and contingency planning while appraising the projects, strengthening credit monitoring, enforcing accountability and addressing corporate governance issues are some of the ways out to stand up to this menace.

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