Varying effects of NPA on Indian Banks: A Literature Survey

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Abstract

Continuous increase in non-performing assets has become a major thought-provoking area for all stakeholders of Indian banking industry. Consistent fund requirements and increasing defaulter rate is resulting to higher non-performing assets and growing interest expenses have put pressure on the bank's profitability. The objectives of the study are to compare and contrast the performance of Indian banking sector with respect to specific emphasis on accumulation of NPA, to identify the causes of increase in NPAs in Indian banks and to recommend the necessary means through which NPA can be reduced to a significant extent. The research paper has undertaken the secondary data available in several research articles published in the different journals of national and international repute downloaded from various websites. Apart from these, various reports available in the numerous domains are also considered as the source of key information inputs. The paper will try to give a glimpse of the literature on NPA management after considering the guidelines of the various committees on banking supervision in order to manage the defaulter risk. The focus of the research work is to identify the scope and direction in line of factors responsible for NPA and what key financials statements need to be observed to land on conclusion regarding the issue of NPA.

Keywords: ***Non Performing Assets; Public sector banks; private sector banks; interest; stakeholders***

1. Introduction

Non-performing Assets (NPA) are the essential component to choose the financial wellbeing and effectiveness of any bank. They influence the operational productivity of the banks, which in terms have impact on the liquidity position, proficiency, solvency and profitability position of the banks. The examination explores the different elements that impact the NPA of banks all over the globe. The investigation likewise involves the work done by different analysts in line of NPA and available norms and way to decrease the NPA and help the banks to discover answer for this issue of increasing non-performing resources.

Aggregations of Non-Performing Assets have turned into a noteworthy risk for Indian financial segment. Banks assume the job of go-between to channelize domestic savings funds into gainful venture to accelerate development of the country. Banks make resources through advance and therefore considered as a major aspect of their business. If they can't understand these benefits, it will be hard for banks to meet their liabilities towards investors and depositors. The management of banks are worried about due to the nature of their advances since advances are the indebted source of wellbeing and increasing profits for them. Resource quality assessment includes estimation of managing, controlling and writing off risk related for the banks. The Basel Committee on Banking Supervision characterizes and acknowledges risk as "potential default of a borrower to meet the commitment as per the concurred term". Achievement of banking is surveyed dependent on benefit and nature of advantage it has from the external forces. In spite of the fact that bank serves social target through its need priority sector financing, keeping up resource quality and productivity is basic for banks' survival and development.

2. Problem Definition

With a view to move towards best banking practices and to ensure greater transparency in the system, it has been decided under the committee recommendations to adopt the '90 days' overdue' norm for identification of NPAs. As per the RBI guidelines, a non-performing asset (NPA) shall be a loan or an advance by the bank whose interest and/or installment of principal remain unpaid for a period of more than 90 days. In respect of a term loan, the account remains non operative for a period of more than 90 days is a dead investment for the bank. In respect of an Overdraft/Cash Credit (OD/CC) where the bill remains overdue/ unpaid for a period of more exceeding 90 days is an alarming situation. With respect to bills purchased and discounted by the banks, interest and/or instalment of principal remains overdue for two harvest seasons but for a period not exceeding two half years in the case of an advance granted for agricultural purposes, any amount to be received remains overdue for a period of more than 90 days in respect of other accounts. Banks are required to classify non-performing assets based on the following three categories depending upon the period for which the asset has remained nonperforming or non-paid up interest or writing off the agreed amount and the realisability of the dues such as substandard assets, bad & doubtful assets and loss incurring assets. The research work would be an attempt to analyse the diverse perspectives of NPA management and key considerations of financial statements proving financial health of the banks in India.

3. Review of Literature

The study undergoes comparative analytical on NPAs of Bank of Baroda & Axis Bank found that during the year 2013-2017, AXIS bank has higher debt compared to Bank of Baroda. While analysing the relationship between NET NPAs and NET PROFIT of both banks it was also found that there is a negative correlation between NET NPAs and NET PROFIT of Bank of Baroda , which means having lesser debts and impact of increases in NET NPAs affects negatively to NET PROFIT and in case of Axis bank there is a positive correlation between NET NPAs and NET PROFIT which shows higher debt with higher income of the bank. It was concluded that while comparing the NPAs of both banks, Bank of Baroda is having a negative correlation, while, Axis bank is having a positive correlation. Timely & prompt Corrective measures & necessary action should be taken to control it, as the old proverb says, "Prevention Is Better than Cure" (**Gadhia, 2018).**

The study evaluated the non – performing assets of Punjab National Bank and its impact on profitability of the bank and also studied the relation between Net Profits, Total Advances, and Gross & Net NPA. The study underwent the annual reports of Punjab National Bank for the period of six years from 2006-07 to 2011-12. It concluded that, there exists a positive relation between Net Profits and NPA of PNB. It was inferred and observed that there was mismanagement on the part of bank which resulted in increasing of NPA **(Narula and Singla, 2014).**

In another research conducted by the researchers studied "Unearthing the Epidemic of Non-Performing Assets: A Study of Public and Private Sector Banks" using the concept of Non-performing assets and analysed the classification of financing and loan assets of public and private sector banks. The examination explored and concluded that the private sectors banks were improving due to decline in NPAs ratio against comparison of Public sector banks due to efficient recovery management carried in managing NPAs and suggested that there is need and want to check the NPAs of public sector banks so that Indian banking system becomes efficient in due course of time **(Arora and Ostwal, 2014).**

The analysis discussed that a major challenge to the Indian banks would be to restructure their poor-quality assets and financing pattern which lead to a high proportion of nonperforming assets. The standards would favour the large banks because of their risk management and minimising expertise and the diversified portfolios. The banks also need to develop new sophisticated computerised tools to reduce their cost of data analysis and also get rid of most of the historical data **(Mehta & Malhotra, 2014).**

The researcher emphasised on identifying the Non-performing assets of Commercial banks in India. This paper witnessed and advocated the various general reasons which convert advances/ assets into NPA and also provided suitable suggestion on findings to overcome the mentioned problem. The study also targeted on the commercial banks to strictly adhering to the task of efficient recovery management system **(Srinivas, 2013).**

The paper provided an insight on the changing dynamics of NPA in risk framework of selected Indian commercial banks and tries to unearth and bring forward the means of interpreting the credit/ defaulter risk arising out of existing levels of bank NPAs. Further, research highlighted the noteworthy steps taken and procedural implementation by major Indian commercial banks, within the public and private sector banks, towards recovering the loans and advances that, falls into the NPA bracket. The research in the paper was based on extensive study of annual publications on performance of public and private sector commercial banks by the Indian Banks Association (IBA). Further, annual reports of commercial banks focused on the study for the year ending March 2012 where it was concluded that problem of NPAs can be tackled only with proper credit assessment, competency evaluation and risk management mechanism of the banking system **(Sikdar and Makkad, 2013).**

In the opinion of researcher, it was observed that rapid changes are taking place in Indian Banking sector; old generation banks in the private sector would be facing many challenges particularly because of their small size. Though the small private sector banks have shown improvements in their corporate control mechanism what is causing concern is the increase in their gross nonperforming assets. Two of the credit segments which are likely to enlarge the NPAs are the retail credit and housing segments. Some of the aggressive private sector banks have been obliging to extend them the housing finance in many cases without even minimum margins. With the floating interest rates moving in the upward direction most of time till recently, banks were making a killing housing finance. Now with many of the IT staff sitting on benches and the pink slips chasing them, the repayments are bound to be affected, necessitating banks to make larger provisions in their balance sheets. Hotels and transport are the other related segments which may experience decline in their revenues. Banks having large exposure to these segments may witness their NPAs inching upwards **(Thingalaya, 2013).**

It was evaluated in the research that, the operational performance of the two public sector banks- State Bank of India and Canara Bank of India for the period of 2007-12. It was observed that the gross NPAs of SBI was higher than those of Central Bank of India **(Vasantbhai, 2013).**

Researchers analysed that there is no significant difference in the ratios of net profit to assets, net profit to deposits, net profit to net worth, net profit to advances, NPA to assets and spread income to assets of Scheduled Commercial Banks (SCB) in India. It was observed that, there is a significant difference in the ratios of interest income to total income, non-interest income to total income and NPA to advances. There exists no significant difference in the growth rates of income, expenditure and profits of SCBs in India **(Selvakumar and Nagalakshmi, 2012).**

Another study examined the NPA of Public Sector banks and Private sector banks of potentially weaker sections for the period seven years in India. The secondary data was evaluated from the Reports on Trends and Progress of Indian Banking Sector. It was assessed that from the period ranging from 2004-10 on applying statistical tool such as percentages and compound Annual Growth rate revealed that the public sector banks have achieved a greater penetration and prominence in recovering NPA as compared to the private sector banks **(Chaudhary and Singh, 2012).**

The researchers in there study named "Unearthing the Epidemic of Non-Performing Assets with Reference to Public Sector Banks in India" presented an empirical and descriptive in nature which showed the magnitude, scale and trend of Public Sector banks in India. It was portrayed that there is a slight improvement in the asset quality reflected by decline in the diverse NPA percentage. The study concluded that NPA is an important parameter for judging, assessing and evaluating the financial performance of banks in terms of profitability, liquidity and economies of scale in operation and banks has to take timely action against degradation of good performing assets **(Hosmani and Hudagi, 2011).**

In following research paper titled "A Comparative Study of Non-Performing Assets of Public and Private Sector Banks" an attempt was made to clarify and explain the concept of NPA, the key factors contributing to increasing of NPAs, the reasons for high NPAs, magnitude of NPAs and their impact on Indian banking operations. Besides capital to risk weight age assets ratio of Public and Private sector banks, management of credit and defaulter risk and measures to control the threat of NPAs were also discussed **(Kaur, 2010).**

In the later study by the researchers it was studied undergoes on NPA management with reference to Karnataka central co-operative bank Ltd., where they elaborated the conceptual data about NPA and on the other hand, they calculated few NPA related ratios and used trend projection method to predict next year advances for the bank. Their finding included the considerable reduction of NPA for the bank and some suggestions for recovery of reducing NPA and ensuring returns **(Monteiro and Ananthan, 2007).**

4. Objectives

The objectives of the paper are:

1. To study NPA, various types of NPA and its causes

2. To analyse ways and means of evaluating NPA and recommend how it can be reduced.

5. Discussion

The various studies targeted towards international best practices that ensures the repayment norms to be adopted stating that NPA will reduced if they adopt 90 days overdue period and it will affect collection with in the given days. The study also inferred and focused attention on following points where;

- Interest and/or installment of principal remain overdue for a period of more than 91 days in respect of a term loan,
- The account remains‘out of order for a period of more than 90 days, in respect of an Overdraft/Cash
- Credit (OD/CC),
- The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,
- Interest and/or installment of principal remains overdue for two harvest seasons but for a period not exceeding two half years in the case of an advance granted for agricultural purposes, and
- Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.
- Non submission of Stock Statements for 3 Continuous Quarters in case of Cash Credit Facility.
- No active transactions in the account (Cash Credit/Over Draft/EPC/PCFC) for more than 91days

Non-performing assets can further be classified into the following three categories depending on the period for which the asset has remained non-performing and the reliability of the dues:

1. Sub-standard Assets: A sub- standard asset is one which has been classified and explained as NPA for a period does not exceeding 12 months.

2. Doubtful Assets: A doubtful asset can be explained as one which has remained NPA for a period that exceeds 12 months.

3. Loss Assets: Where loss has been observed and identified by the banks, internal or external auditor or central bank inspectors. But the amount has not been written off and recovered wholly or partly.

Reasons for Occurrence of NPAs

The Bad Loans or default in financial repayment in terms of principle and interest are termed as NPAs. When the borrower is unable to meet financial obligations, say non-payment of a loan installment. These loans can occur due to the following reasons:

- Bad lending practices/ Usual banking operations
- A banking crisis (as happened in South Asia and Japan)
- Loss Projected on components (due to environmental reasons, natural calamities, business cycle, Disease Occurrence, etc.)
- Incremental component (due to internal bank management, like credit policy, terms of credit, etc.)

The Problems caused by NPAs

NPAs do not just reflect badly in a bank's account books, they adversely impact the national economy.

Following are some of the effects of NPAs:

- Depositors do not get rightful returns and many times may lose uninsured deposits. Banks may begin charging higher interest rates on some products to compensate Non-performing loan losses
- Bank shareholders are adversely affected
- Bad loans imply redirecting of funds from good projects to bad ones. Hence, the economy suffers due to loss of good projects and failure of bad investments
- When bank do not get loan repayment or interest payments, liquidity problems may ensue.

Causes of NPA

There are various factors that are directly influencing growth of nonperforming loans. These determinants can be explained into two categories micro and macroeconomic factors for the sake of simplicity.

Micro Economic Factors influencing NPAs

Micro economic factor mainly draws attention towards the causes which are specific to a particular bank. The Non-Performing Assets which is the proportion of the problematic loans to total loans for bank throughout the year is expected to be positively related to restructured loan because the non-performing loans of one year are not completely written off and has a carryover effect on the performance of the bank. It can be observed as:

- The credit growth in one year could be influential on the loan defaults in the subsequent years since credit requirement of banks during inflation period overlook strict credit criteria. Hence it is also positively related to NPA of the given bank.

- Expansion in the branches of Bank into new areas can have an influential impact on the problem of loans due to lack of familiarity with the customers in the new locality, so it could also affect the NPA adversely.
- The notable factor that may influence indirectly to the level of loan can be the size of the bank with reference to its total assets.
- Political interventions and ineffectively enforced laws can be one of the reasons majorly responsible for enhancing NPA.
- Increasing corruption at various levels and growing competition among banking players also lead to higher accretion of NPAs.
- The another way of detecting the NPA can be the shift from manual recognition of Non-performing loans to a mandatory system (by RBI) based mechanism as prescribed in legal framework. In the investigation, most of the managers informed that earlier they may have a chance to manipulate the non-performing assets recognition but now the information system shows and blinks automatically indicating the increasing level of NPA. Hence the collective NPA which were hidden by manual recognition have come out suddenly and shown the disastrous increase.
- Indian Banks are attracted to high loan because they are allowed to lead up to 15% capital to single corporate & to a single conglomerate it is at a level of 40% (excluding infrastructure) and if a corporate or conglomerate related to priority sector namely Infrastructure Bank can land up to 20% to 50% respectively. As the banks are stretching these limit, they would expose to a very high degree of risk leading to a high chance of default.

Macro-Economic Factors determining NPAs

Some macroeconomic factors that may portrays direct influence on the credit/ defaulter risk namely the GDP and the Inflation.

- The evidences suggest that higher GDP growth will observe a negative correlation with current NPA hence, Gross Domestic Product (GDP) can significantly influence the borrower's ability during repayment the loans.
- Inflation can have a lasting affect on the purchasing power of consumers; hence it is expected to have direct effect on the personal disposable income and directly influence the NPA of banks. Thus, GDP growth and NPA could be inversely related while a positive correlation is expected between Inflation and NPA.
- Interest rate is another macroeconomic factor that may have directly influence on the Non-performing asset as high interest rate decreases the profit margin and simultaneously reduces the ability to repay the loan.
- Banks have observed that, due to reduced demand, capital constraint and risk aversion there is shrink in credit as it reached to a multiyear low. Banks have failed to reduce base rate or they are unable to match with the rates offered by debt capital market instruments especially to corporate players which have high credit ratings.
- Non performing loans piled up due to factors such as ban on mining projects and delayed clearances, which affected the power, iron and steel sectors in particular. Volatility in price or raw material and shortage of power has impacted the operations of textile, iron & steel and infrastructure companies.

6. Financial Impact of NPA

The various studies focused upon the varying impact and changing relation of NPA on Ratios and Financial statements. The financial statements are true predictors of financial health and wellbeing of the banks any change in NPA will be shown by increase or decrease in financial statements of the company. The researches were made to reveal such lasting effects stating the view that it is majorly banks' adopt aggressive credit lending policy which drives the growth of non-performing assets in their balance sheets (Mcgoven,1993). The analytical exercise was also carried by other researchers with reference to net worth, liabilities, assets, income, expenditure, profitability and efficiency of different groups in the banking system. The study revealed that by and large, the public sector banks lagged far behind the foreign and private sector banks in respect of all the variables analysed. The researcher suggested that commercial banks should be redefined in such a way that that there exist a co-ordination between the commercial viability and social responsibility of the public sector banks (Sreedhran,1996). (Thiagarajan, S. and Ramachandran, A., 2011) analysed the defaulter risk component of the Indian Banking sector using financial data for the period 2001-2010 and examined the use of certain key credit risk ratios to measure the defaulter risk. It was comprehending that ratio analysis result in gradually decreasing in the ratio of NPA to total loans for both public and private sector banks from 2001 to 2010. Their findings are consistent with the findings that although a similarity exists in movement of selected ratios, the sector wise comparison showed significant differences among different bank groups. Thus financial statement are true predictors of financial health and all decision related to NPA is reflected out of Ratios, P&L Account and Balance Sheet of the bank.

7. Conclusion

The study concludes that NPA is one of the most important and key issue to be managed and controlled on the part of banks. The rising of NPA is setback to the banks and they can be on a backfoot if proper recovery system is not developed and steps in line to its recovery may not be taken. Hence the objective stating the types and effect of NPA stands clear that it can produce shocks to both banks and economy because the rising defaulter rate should be controlled by way of efficient recovery system. The time for interest collection should be reduces and proper credit worthiness and financial standing must be accessed. Apart from it banks should develop the system to take a strict action against defaulters so that the payment should be ensured and promised. Interest rate should also be at a managed float so that the banks may not suffer loss of repayments of interest. Financial Statements and records must be carefully evaluated so as to keep a track of NPA and manage it to its minimum level. The ratio namely cash-deposit ratio, credit-deposit ratio, net interest margin, profit per employee, return on assets and ratio of return on equity representing the liquidity, efficiency, solvency and profitability of the Indian commercial banks represent the state of the Indian commercial banks. Hence decision can be framed easily to ensure smooth functioning of the banks. NPA is a virus that affect growth of banking sector. It also affects liquidity and profitability through posing threat on quality of asset and survival of banks. PSBs are exposed to larger asset quality implications because they are the prime lender to crucial and slow sectors like power and agriculture which face substantial losses during the economic slowdown. Hence it is recommended that if the banks need to manage NPA strong recovery mechanism should be ensured so that the banks may not incur losses and financial indicators are key predictors of financial health to ensure harmony continuous appraisal and feedback mechanism should be developed.

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