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Non-Performing Assets in Indian Banking-The Magnitude and Trends

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Abstract: The Non-Performing Advances hit banks in several ways. Not only banks lose income on these advances, but they have also to incur heavy recurring expenditure to maintain them in their books. Banks have to ensure adequate capital, maintain reserve requirements, pay interest on deposits, incur legal and other miscellaneous expenses, make provisions on loan losses and above all maintain an image as if nothing has gone wrong with their inherent strengths. The impact of NPAs results in lower interest rates to depositors, higher intermediation cost, higher rates of interest to borrowers, higher rates of service charges to all customer, more provisions towards loan losses, more capital contribution and less return to share holders by way of dividend.
Key words: Non-performing, banking structure, Public sector

Introduction

Banks play an important role in economic development of a country in mobilization of community's savings and deployment of funds to the productive sectors of the economy. Loans and advance are assets of the banks as they play an important part in gross earnings and net profits of banks. Public sector banks have achieved a reasonable degree of success to having down their existing non-performing assets but due to heavy slippage of standard accounts to non-performing assets category the overall position continues to deteriorate. In this chapter, an effort has been made to deal with management on non-performing assets in public sector banking during post-reforms period.

Non-performing assets a drag on banks profitability and inhibit their lending ability. Such assets generally include loans to the borrowers who do not pay the installments, rendering their accounts irregular or out of order for a period more then 180 days such as on banks balance sheet date. After an account is classified as non-performing, a bank can not account for interest charged in the account as its income for the current as well as for the previous year to the extent it was not realized. Further, it cannot also take further interest to income till the account remains in non-performing assets category. Thus non-performing assets act as double edged knife and affect banks profitability in two ways (i) de-recognition of interest income and (ii) substantial loans loss provisions on such accounts. They are also termed as bad assets. In India, the RBI monitors the entire banking system and, as defined by the country's central bank, if for a period of more than 90 days, the interest or installment amount is overdue then that loan account can be termed as a Non-Performing Asset.

The share of advances in the total assets of the banks forms more than 60 per cent and as such it is the back bone of banking structure. Bank lending is very crucial for it makes possible the financing of agricultural, individual and commercial activities of the country. The strength and soundness of the banking system primarily depends upon health of the advances. In other words, improvement in assets quality is fundamental to strengthening the working of banks and improving their financial viability.

Of the different categories of assets of banks the two categories, investments and advances generally constitute 90 per cent of the total assets of any commercial bank. Here the NPA concept is restricted to loans and advances. Hence, a concerted effort to minimize the amount of non-performing assets in these two categories of assets may greatly boost the bottom line of banks. This is, however, in no way to minimize the importance of similar efforts in case of other four categories of assets. In the present chapter, an attempt is made to study the concept of non-performing loan assets which constitute generally more than 55 per cent of the total assets of a typical bank in India.

NPAs' - A Conceptual Focus

The two important functions of commercial bank are the receipt of deposits and granting of loans. Receipt of deposits becomes liabilities and the liabilities become assets as the deposits are granted as loans. It is also known as liability assets transformation. Joseph F. Sinkeys says "Transformation of banks liabilities and equity into assets can be viewed as a production process. The quality of these assets determines the viability of the system". During the recent past the quality of advances has been deteriorating for which unprecedented rise in non-performing advances is evidence. As for back as in 1977, the Securities and Exchange Commission of the United States defined non-performing loans as "Loans which are contractually past due for 60 days or more as to interest or principal payments; and loans, the term of which has been renegotiated to provide a reduction or deferral of interest or principal".

Conceptually A loan or lease that is not meeting its stated principal and interest payments. A loan is an asset for a bank as the interest payments and the repayment of the principal amount create a stream of cash flows. Banks usually treat assets as non-performing if they are not serviced for some time. If payment has not been made as of its due date then the loan gets classified as past due. Once a payment becomes really late the loan gets classified as non-performing. A non performing asset (NPA) is a loan or advance for which the principal or interest payment remained overdue for a period of 90 days.

Classification of NPAs

There are two types of NPAs (i) Gross NPAs and (ii) Net NPAs

(i) Gross NPA: Gross NPA is the sum total of all loans assets that are classified/declared as per the RBI guidelines as on a balance sheet date. It is defined as the ratio of gross NPA to gross advances of the bank.

$$\text{Gross NPA Ratio} = \frac{\text{Gross NPAs}}{\text{Gross Advances}} \times 100$$

Gross NPA Ratio indicates the quality of credit portfolio of the bank. High gross ration indicates low quality credit portfolio. The international prescribed level of gross NPA is 5 per cent.

The percentage of gross NPA to advances includes interest suspense account where the bank is following the accounting practice of debiting interest to the customer's account and crediting interest suspense account.

(ii) Net NPA: Net NPA is determined by deducting from gross NPAs by excluding.

(i) Balance in interest suspense account (ii). DICGE/ECGC claims received and kept in suspense account pending adjustment (for final settlement, (iii). Part payment received and kept in suspense account and (IV). Total provision held. The net NPA ratio is the ratio of net NPA to net advances expressed; in terms of percentage.

$$\text{Net NPA Ratio} = \frac{\text{Net NPAs}}{\text{Net Advances}} \times 100$$

$$= \frac{\text{Gross NPAs} - \text{Provisions}}{\text{Gross Advances} - \text{Provisions}} \times 100$$

It indicates the degree of risky ness in the credit portfolio of the bank. High net NPA ratio indicates the high quantity or risky loans in the bank for which non-provision has been made. As per the international standards the net NPA should not be more than 2.5 per cent.

The Non-Performing Advances hit banks in several ways. Not only banks lose income on these advances, but they have also to incur heavy recurring expenditure to maintain them in their books. Banks have to ensure adequate capital, maintain reserve requirements, pay interest on deposits, incur legal and other miscellaneous expenses, make provisions on loan losses and above all maintain an image as if nothing has gone wrong with their inherent strengths. The impact of NPAs results in lower interest rates to depositors, higher intermediation cost, higher rates of interest to borrowers, higher rates of service charges to all customer, more provisions towards loan losses, more capital contribution and less return to share holders by way of dividend. All these costs are finally passed on to the Government, which is forced to bail out the banks through its budgetary provisions. This means that ultimately the tax payers bear the cost of Non-Performing Advances for no fault of theirs.

Non-Performing Advances also cost the economy in several ways. Money borrowed for investments, if not properly utilized affects creation of assets and growth of the economy, generation of employment, demand and supply for goods and services, resulting in inflationary pressure and finally the fiscal discipline of the nation. It also adds to the cost of funds for performing borrowers (who over a period of time have to put up with the general increase in the cost of funds) resulting in higher cost of production with all attendant consequences. The multiplier effect of this huge sum, if that amount is made to perform, would certainly help the Government to significantly bring down fiscal deficit all round and foster consequent benefits on all fronts of income as well. The reputation of all banks and that of Non-Performing banks in particular, can also get refurbished, which is essential in the current context of globalization and integration of domestic financial market with the international market.

Thus, Non-Performing Advances are not the problem confined to banks, but a national problem for the whole economy, with international ramifications. The problem of Non-Performing Advances is not unique to India and exists at moderate and tolerable levels in all other banking countries as well. NPAs are pronounced and more common in developing and underdeveloped countries. Even Non-Performing banks in other advanced countries are either inherently strong enough to absorb temporary set-backs and losses or go into liquidation or are sometimes taken over under mergers and acquisitions.

Table-1: Gross NPAs of Scheduled Commercial Banks During 1996-97 To 2008-09 (Rs. in Crores)

Year	Gross Advances	Gross Non Performing Advances	Total Assets	Gross NPAs' as a %of Gross Advances	Gross NPAs' as % of Total Assets
1996-97	301698.00	47300.00	672975.13	15.70	7.00
1997-98	352696.00	50815.00	795535.30	14.40	6.40
1998-99	399436.00	58722.00	950897.97	14.70	6.20
1999-00	475113.00	60408.00	1105464.38	12.70	5.50
2000-01	558766.00	63741.00	1295405.34	11.40	4.90
2001-02	680958.00	70861.00	1536424.47	10.40	4.60
2002-03	778043.00	68717.00	1699197.46	8.80	4.00
2003-04	902026.00	64786.00	1974017.00	7.20	3.30
2004-05	1110986.00	58300.00	2355982.67	5.20	2.50
2005-06	1516723.00	51078.00	2785640.00	3.36	1.83
2006-07	1981032.00	50410.00	34278206.00	2.54	0.14
2007-08	2477762.00	56322.00	4327322.00	2.27	1.30
2008-09	2994334.00	68850.00	5230308.00	2.29	1.36
CARG	19.31	2.93	17.08	. .	. .

Source: Compiled from RBI Report on Trend and Progress of Banking in India: Relevant Issues

Gross NPAs of Scheduled Commercial Banks: The Gross NPAs of Scheduled commercial banks in relation to the total assets and the Gross advances, during 1996-97 to 2008-09, are presented in Table 1. As evident from the table the gross advances of scheduled commercial banks during 1996-97 were Rs. 301698 crores which increased to Rs. 2994334 crores during 2008-09 with a growth rate of 19.31 per cent. As against this, the gross NPAs experienced a growth rate of 2.93 per cent increasing from Rs. 47300 crores in 1996-97 to Rs. 68850 crores during 2008-09. A further look into the table reveals that the gross NPAs as a percentage of gross advances and also the total assets which were respectively at 15.70 per cent, and 7 per cent during 1996-97 have gradually and consistently rolled down to stand at 2.29 per cent and 1.36 per cent respectively during 2008-09. Thus the gradually declining trend of the ratio of Gross NPAs to gross advances and also to total assets during the period under reference un equivocally shows that the intensity of gross NPAs thou, absolutely went up at a compound annual growth rate of 2.93 per cent, the incidence a gradually come down in relation to the gross advances and total assets as evident from the virtually slowing down ratio of gross NPAs between 1996-97 to 2008-09.

Table-2: Net NPAs of Scheduled Commercial Banks During 1996-97 To 2008-09 (Rs. in Crores)

Year	Net Advances	Net Non-Performing Advances	Total Assets	Net NPAs as % Of Net Advances	Net NPAs as a % of Total Assets
1996-97	276421.00	22340.00	672975.13	8.10	3.30
1997-98	325522.00	23761.00	795535.30	7.30	3.00
1998-99	367012.00	28020.00	950897.97	7.60	2.90
1999-00	444292.00	30073.00	1105464.38	6.80	2.70
2000-01	526328.00	32461.00	1295405.34	6.20	250
2001-02	645859.00	35554.00	1536424.47	5.50	2.30
2002-03	740473.00	32671.00	1699197.46	4.40	1.90
2003-04	862643.00	24617.00	1974017.00	2.90	1.20
2004-05	1074044.00	21441.00	2355982.67	2.00	0.90
2005-06	1516723.00	18535.00	2785640.00	1.22	0.66
2006-07	1981032.00	20265.00	3458206.00	1.02	0.58
2007-08	2477762.00	24738.00	4327322.00	0.99	0.57
2008-09	2994334.00	31402.00	5230308.00	1.04	0.60
CARG	20.11	2.65	17.08	. .	. .

Source: Compiled from RBI Report on Trend and Progress of Banking in India: Relevant Issues

Net NPAs‘of Scheduled Commercial Banks

Table -2 presents the Net NPAs of Scheduled commercial banks in relation to the Net advances and the total assets during 1996-97 to 2008-09. The scenario of the growth trend of the Net advances is similar to that of the gross advances. It is evident from the table the amount of Net advances and the total assets of the Scheduled commercial banks which were respectively at Rs. 276221 crores and Rs. 672975.13 crores during 1996-97, went up to stand at Rs. 2994334 crores and Rs. 5230308 crores during 2008-09 with the respective growth rates of 20.11 per cent and 17.08 per cent over the years under review. The Net NPAs, on the other hand which were Rs. 22340 crores in 196-97 crept up to Rs. 35554 crores (2001-02) and stood at Rs. 31402 crores during 2008-09 witnessing a growth rate of only 2.65 per cent. This analysis shows that, during 1996-97 to 2008-09 the pace of growth the Net NPAs of Scheduled commercial bank's with for below (2.65 per cent) as against. 20.11 per cent the amount of Net advances 17.08 per cent in the total assets.

The Increasing Incidence of NPAs

Table 3 presents the gross and Net NPAs of the scheduled commercial banks as a whole and also bank group wise. As could be seen from the table, the gross NPAs of the schedule commercial banks as a percentage of the gross advances which was 3.3 per cent in the year 2005-06 stood at 9.3 per cent in the year 2016-17. On the other hand the NPAs as a percentage of the total assets which was 1.9 per cent in 2005-06 stood at 5.6 per cent in the year 2016-17.Further, the NPAs as a percentage of the Net Advances of the total scheduled commercial banks was 1.2 per cent in 2005-06 and stood at 5.3 per cent in the year 2016-17. Still to state, the Non performing Assets as percentage of the net total assets of the scheduled commercial banks which were only 0.7 per cent in 2005-06 stood at 3.1 per cent in the year 2016-17.The scenario of the NPAs in the case of the public sector banks during the same period appears to be on a different scale. It is evident from the fact that the gross NPAs as a percentage of the gross advances and the gross total assets respectively of the public sector banks in the year 2005-06 were 3.7 per cent and 2.1 per cent stood at 11.7 per cent and 7.0 per cent in the year 2016-17. Thus the analysis shows that the gross scenario of the NPAs, as a proportion of the gross advances as well as the proportion of the total advances experienced a phenomenal growth over the years under reference both in the case of the scheduled commercial banks in general and also the public sector banks in particular.

Reasons for the growth opf NPAs

The reasons for the growth of NPAs include Corporate,Economic, Politicaland a host of others.The economic reasons include Diversion of funds by companies for purposes other than for which loans were taken. Due diligence not done in initial disbursement of loans. Inefficiencies in post disbursement monitoring of the problem. Restructuring of loans done by banks earlier to avoid provisioning. Post crackdown by RBI, banks are forced to clear their asset books which has led to sudden spurt in NPAs. During the time of economic boom, overt optimism shown by corporates was taken on face value by banks and adequate background check was not done in advancing loan. In the absence of adequate governance mechanism, double leveraging by corporates, as pointed out by RBI's Financial Stability Report.

Table-3 : Gross and Net NPAs of Scheduled Commercial Banks Bank Group-Wise

(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
Scheduled Commercial Banks								
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
Public Sector Banks								
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

The Economic Reasons include Economic downturn seen since 2008 has been a reason for increasing bad loan. Global demand is still low due to which exports across all sector has shown a declining trend for a long. In the case of sectors like electricity, the poor financial condition of most SEBs is the problem; in areas like steel, the collapse in global prices suggests that a lot more loans will get stressed in the months ahead. Economic Surveys of India mentioned over leveraging by corporate as one of the reasons behind rising bad loans. Another factor that can contribute to the low level of expertise in many big public sector banks is the constant rotation of duties among officers and the apparent lack of training in lending principles for the loan officers. Poor recovery and use of coercive techniques by banks in recovering loans.

Recent developments and Initiatives to tackle NPAs

Insolvency and Bankruptcy Code (IBC) – With the RBI's push for the IBC, the resolution process is expected to quicken while continuing to exercise control over the quality of the assets. There will be changes in the provision requirement, with the requirement for the higher proportion for provisions going to make the books better.

Credit Risk Management – This involves credit appraisal and monitoring accountability and credit by performing various analysis on profit and loss accounts. While conducting these analyses, banks should also do a sensitivity analysis and should build safeguards against external factors.

Tightening Credit Monitoring – A proper and effective Management Information System (MIS) needs to be implemented to monitor warnings. The MIS should ideally detect issues and set off timely alerts to management so that necessary actions can be taken.

Amendments to Banking Law to give RBI more power – The present scenario allows the RBI just to conduct an inspection of a lender but doesn't give them the power to set up an oversight committee. With the amendment to the law, the RBI will be able to monitor large big accounts and create oversight committees.

More "Hair-cut" for Banks – For quite some time, PSU lenders have started putting aside a large portion of their profits for provisions and losses because of NPA. The situation is so serious that the RBI may ask them to create a bigger reserve and thus, report lower profits.

Stricter NPA recovery – It is also discussed that the Government needs to amend the laws and give more power to banks to recover NPA rather than play the game of "wait-and-watch."

Corporate Governance Issues – Banks, especially the public sector ones, need to come up with proper guidance and framework for appointments to senior level positions.

Accountability – Lower level executives are often made accountable today; however, major decisions are made by senior level executives. Hence, it becomes very important to make senior executives accountable if Indian banks are to tackle the problem of NPAs.

The banks should also consider "**raising capital**" to address the problem of NPA.

1. **Using unclaimed deposits** – Similar to provisions for unclaimed dividends, the government may also create a provision and transfer unclaimed deposits to its account. These funds in return can be transferred to banks as capital.

2. **Monetization of assets held by Banks** – In this case, banks with retail franchisees should create value by auctioning a bank assurance association rather than running it themselves as an insurance company. The current set-up blocks capital inflows and doesn't generate much wealth for the owners.

3. **Make Cash Reserve Ratio (CRR) attractive** – At present, the RBI asks Indian banks to maintain a certain limit on CRR on which the RBI doesn't pay interest and hence, banks lose out a lot on interest earnings. If the CRR is made more financially rewarding for banks, it can reduce capital requirements.

4. **Refinancing from the Central Bank** – The US Federal Reserve spent $700 billion to purchase stressed assets in 2008-09 under the "Troubled Asset Relief Program." Indian banks can adopt a similar arrangement by involving the RBI directly or through the creation of a Special Purpose Vehicle (SPV).

5. **Structural change to involve private capital** – The compensation structure and accountability of banks create a problem for the market. Banks should be governed by a board while aiming to reduce the government's stake and making the financial institutions attractive to private investors.

With the potential solutions above, the problem of NPAs in Indian banks can be effectively monitored and controlled, thus allowing the banks to achieve a clean balance sheet. Looking at the giant size of the banking industry, there can be hardly any doubt that the menace of NPAs needs to be curbed. It poses a big threat to the macro-economic stability of the Indian economy. An analysis of the present situation brings us to the point that the problem is multi-faceted and has roots in economic slowdown; deteriorating business climate in India; shortages in the legal system; and the operational shortcoming of the banks. The recommendations given by RBI are a welcome step in this regard.

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